



1991

Ending the Turf Wars: Support for a CFTC/SEC Consolidation

John D. Benson

Follow this and additional works at: <https://digitalcommons.law.villanova.edu/vlr>



Part of the [Securities Law Commons](#)

Recommended Citation

John D. Benson, *Ending the Turf Wars: Support for a CFTC/SEC Consolidation*, 36 Vill. L. Rev. 1175 (1991).

Available at: <https://digitalcommons.law.villanova.edu/vlr/vol36/iss5/7>

This Comment is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.

1991]

Comments

ENDING THE TURF WARS: SUPPORT FOR A CFTC/SEC CONSOLIDATION

I. INTRODUCTION

In 1974, when Congress was considering sweeping amendments to the Commodities Exchange Act (CEA),¹ the White House contacted Ray Garrett, Chairman of the Securities and Exchange Commission (SEC), offering to give the SEC regulatory jurisdiction over the commodity futures industry.² Chairman Garrett refused the offer, and Congress subsequently created the Commodity Futures Trading Commission (CFTC) to do the job.³ Since then, the two agencies have waged almost constant war over the boundaries of their respective jurisdictions.⁴ This conflict has been fueled in particular by the advent of hybrid financial instruments that have characteristics of both futures and securities⁵ and new trading strategies in which investors trade in the futures and securities markets almost interchangeably.⁶ Recently, the SEC has aggressively advocated a merger of the agencies while the CFTC has been fighting for its very existence.⁷ This interagency feud has contributed to in-

1. 7 U.S.C. §§ 1-26 (1988). The amendments were known as the Commodity Futures Trading Commission Act of 1974 and were enacted as various amendments to the existing sections of the Commodity Exchange Act. *Id.*

2. Schneider & Schapiro, *What Corporate Lawyers Should Know About Commodity Futures Law*, in 21ST ANN. INST. ON SEC. REG. 71 (Practising Law Institute 1990).

3. *Id.*

4. See *Board of Trade v. S.E.C.*, 677 F.2d 1137, 1149-50 (7th Cir.) (tracing disputes between agencies from 1975 to 1978), *vacated as moot*, 459 U.S. 1026 (1982). For a further discussion of this case, see *infra* notes 93-99 and accompanying text. For a further discussion of later disputes and proposed resolutions, see *infra* notes 100-47 and accompanying text.

5. The best example of a financial instrument with characteristics of both a security and a future is the index participation. For a further discussion of index participations and the inability of the present jurisdictional system to regulate such products, see *infra* notes 104-24 & 235-41 and accompanying text. For a further discussion of proposals to enable index participations to be traded, see *infra* notes 128-47 and accompanying text.

6. See Schick, *A Review and Analysis of the Changing Financial Environment*, 44 BUS. LAW. 43 (1988) (advocating SEC jurisdiction over all securities-related financial instruments).

7. See *Financial Market Regulatory Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 1st and 2d Sess. 369 (1987-1988) [hereinafter *Financial Market Hearings*] (discussing opposition to giving SEC authority over index futures); see also SEC, *Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990).

(1175)

creased market volatility,⁸ uncertainty in the hybrid instrument markets,⁹ the flight of investment funds overseas¹⁰ and a stifling of financial innovation.¹¹ For these reasons, as well as others to be discussed, it is submitted that Congress should end this incessant battling by consolidating the SEC and the CFTC into a single regulatory agency with jurisdiction over all aspects of the futures and securities industries.¹²

This Comment will begin by overviewing the futures and securities industries and the roles that the CFTC and the SEC play in regulating those industries.¹³ The next section will trace the history of disputes between the agencies, with particular emphasis on the fight over Government National Mortgage Association (GNMA) options and stock index participations.¹⁴ The third section will highlight current proposals for resolving the jurisdictional disputes.¹⁵ The final section will set forth the factors mandating a consolidation of the agencies, as well as the factors that will facilitate such a consolidation.¹⁶

II. THE CFTC AND THE FUTURES INDUSTRY

A. *Futures Contracts*

In general, a futures contract is an agreement between a seller (a

8. See REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, reprinted in [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,078 (Jan. 8, 1988) [hereinafter BRADY REPORT] (failure of market segments to act as one contributed to 1987 market break). For a further discussion of the present jurisdictional system's inability to effectively address the problem of market volatility caused by intermarket trading, see *infra* notes 153-207 and accompanying text.

9. Schneider & Schapiro, *supra* note 2, at 83. For a further discussion of the uncertainty faced by the hybrid instrument industry, see *infra* notes 235-47 and accompanying text.

10. Patrikis, *New Product Issues*, in NEW DEVELOPMENTS IN COMMODITY FUTURES REGULATION AND ENFORCEMENT 1989, at 469, 472 (1989) (Practising Law Institute, Corporate Law and Practice Course Handbook No. 667) (describing flight of swaps market to Europe).

11. See *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537 (7th Cir. 1989) (holding that index participations could not be traded on securities exchanges), *cert. denied*, *American Stock Exchange, Inc., v. Chicago Mercantile Exchange*, 110 S. Ct. 3214 (1990). For a further discussion of how the jurisdictional conflicts have stifled financial innovation, see *infra* notes 235-47 and accompanying text.

12. For a full discussion of the factors mandating and facilitating a consolidation of the agencies, see *infra* notes 148-302 and accompanying text.

13. For a discussion of the futures industry and the CFTC, see *infra* notes 17-53 and accompanying text. For a discussion of the securities industry and the SEC, see *infra* notes 54-80 and accompanying text.

14. For a discussion of the disputes between the agencies, see *infra* notes 81-127 and accompanying text.

15. For a discussion of current proposals aimed at resolving the jurisdictional disputes, see *infra* notes 128-47 and accompanying text.

16. For a discussion of the factors mandating and facilitating a consolidation of the agencies, see *infra* notes 148-302 and accompanying text.

“short”) and a buyer (a “long”) to deliver or take delivery of a specified commodity,¹⁷ at a specified price, on a specified date in the future.¹⁸ Although the contract imposes binding obligations on both parties when formed, actual performance of these obligations is not required until the date set for delivery, the expiration date of the contract.¹⁹ A futures contract, therefore, has two primary characteristics: bilateral obligations and futurity.²⁰ Delivery, however, is not an essential element of a futures contract despite the apparent requirement that a commodity be delivered at some point in the future.²¹ Indeed, although the sale of the underlying commodity appears to be the primary function of a futures contract, over ninety-five percent of all futures contracts are extin-

17. Section 2 of the Commodities Exchange Act defines a commodity as follows:

wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in

7 U.S.C. § 2 (1988). Thus, anything, except onions, can become a commodity simply by having a futures contract based on it.

Futures contracts were developed in the eighteenth century to counteract the unavoidable price fluctuations caused by seasonal changes in commodity supplies. STAFF OF GENERAL ACCOUNTING OFFICE, SECURITIES AND FUTURES, *HOW THE MARKETS DEVELOPED AND HOW THEY ARE REGULATED* 65-66 (1986) [hereinafter GAO STAFF STUDY]. While most early futures contracts resulted in actual delivery of the underlying commodity, futures traders soon learned that extinguishing their positions through offset was more profitable than requiring delivery. *Id.* at 66 (citing THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE COMMODITY FUTURES COMMISSION & SECURITIES AND EXCHANGE COMMISSION, *A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS*, ch. 3, at 5-6 (1984)).

18. 1 P. JOHNSON & T. HAZEN, *COMMODITIES REGULATION* § 1.03 (2d ed. 1989). A futures contract differs from forward contracts and spot transactions, two other commodities transactions that are exempt from CFTC regulation under § 2 of the Commodity Exchange Act. *Id.*; see also 7 U.S.C. § 2 (1988). A forward contract is a present sale of a commodity with a provision for future delivery. 1 P. JOHNSON & T. HAZEN, *supra*, § 1.03. A spot transaction is a present sale of a commodity with a provision for immediate delivery. *Id.* § 1.09. Since the vast majority of farmers sell their crops through forward contracts, futures have only a secondary impact on the agricultural economy. GAO STAFF STUDY, *supra* note 17, at 64.

19. See 1 P. JOHNSON AND T. HAZEN, *supra* note 18, § 1.03.

20. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 541 (7th Cir. 1989), *cert. denied*, *American Stock Exchange, Inc., v. Chicago Mercantile Exchange*, 110 S. Ct. 3214 (1990). Futurity means that the value of the contract is set in the future. *Id.*

21. *Id.* at 542. In fact, many futures contracts, particularly those based on financial commodities such as stock indices and interest rates, are entirely incompatible with a delivery requirement. *Id.*

guished before delivery²² through the taking of offsetting positions in different, but identical contracts.²³

Two fundamentally different groups trade in futures contracts. The first group, known as hedgers, uses futures contracts to protect themselves against price swings in the underlying commodity.²⁴ Normally, a hedger will acquire a position in the futures market that is directly opposite to the position the hedger has in a commercial transaction.²⁵ A hedger, therefore, normally does not trade in futures contracts for their profit potential. The second group of traders, known as speculators, basically bets that the value of the contract will increase or decrease before the expiration date.²⁶ The speculator has no real interest in the underlying commodity; the focus is on the price of the contract and its profit potential.²⁷ Although many commodity producers believe that speculators cause volatile commodities prices, studies indicate that speculation is beneficial to the "liquidity, efficiency, and competitiveness of the [futures] markets."²⁸ Such speculation also enables futures transactions to perform their two basic functions: discovery of future commodities prices and hedging.²⁹

B. *Futures Exchanges*

The Commodities Exchange Act provides that all futures transactions must occur on a registered futures exchange.³⁰ At present, futures are traded on thirteen exchanges, with the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) being the largest and most prominent exchanges.³¹ Several of the futures exchanges

22. GAO STAFF STUDY, *supra* note 17, at 63. Hedgers are most likely to take delivery of the underlying commodity; speculators almost always offset their contracts. *Id.* For further discussion of the roles of hedgers and speculators, see *infra* notes 24-29 and accompanying text.

23. *Chicago Mercantile*, 883 F.2d at 542. A futures contract can be extinguished either through offset, which is the taking of an opposite position in a different but identical contract, or by cash settlement. *Id.* If the parties decide to settle in cash, settlement is based on changes in the value of the contract. *Id.*

24. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.12.

25. *Id.*

26. GAO STAFF STUDY, *supra* note 17, at 63.

27. *Id.*

28. *Id.* Futures trading has often been criticized by farmers who believe that speculation causes "spectacular price fluctuations and manipulation" in the underlying commodities markets. *Id.* at 67. For this reason, many states considered outlawing futures trading before the federal government began regulating it. *Id.*

29. See *Board of Trade v. S.E.C.*, 677 F.2d 1137, 1151 (7th Cir.) ("[T]rading serves legitimate hedging and price discovery functions, thereby facilitating production of the underlying commodity."), *vacated as moot*, 459 U.S. 1026 (1982).

30. 7 U.S.C. § 2a(ii), (v) (1988).

31. GAO STAFF STUDY, *supra* note 17, at 11. Futures are presently traded on the Chicago Mercantile Exchange, Chicago Board of Trade, Mid-America

are subsidiaries of registered securities exchanges, thereby ensuring that certain exchange officials will have contact with both the SEC and the CFTC.³²

The exchange itself is physically structured so that each futures contract has its own trading area known as a pit.³³ In the pits, trading occurs using the open outcry method, in which traders verbally establish contract prices in competitive bidding.³⁴ Although a futures contract is originally formed by a buyer and a seller, the exchange's clearinghouse is the party that ultimately takes the position opposed to both the buyer and the seller.³⁵ It is this interposition that allows a futures participant to offset his obligations by taking an opposing position in a different, but identical contract.³⁶

C. *Commodities Exchange Act*

By 1974, the federal government had over fifty years of experience regulating the futures industry.³⁷ Rising food prices and grain shortages, coupled with manipulative activities in the futures markets, led Congress to enact sweeping amendments patterned after the Securities Exchange Act of 1934³⁸ to the CEA.³⁹ The major provision of the 1974 amendments was the creation of the Commodity Futures Trading Commission, an independent federal agency patterned after the Securities and Exchange Commission, with jurisdictional authority over the

Commodity Exchange, Chicago Rice and Cotton Exchange, New York Cotton Exchange, New York Futures Exchange, Commodity Exchange, Inc., Coffee, Sugar and Cocoa Exchange, New York Mercantile Exchange, Amex Commodities Corporation, Kansas City Board of Trade, Philadelphia Board of Trade and Minneapolis Grain Exchange. *Id.* at 9. Seventy-five percent of all futures are traded on the CBOT and the CME. *Id.* at 11.

32. *Financial Market Hearings*, *supra* note 7, at 499 (testimony of John Phelan, President of the New York Stock Exchange); *see also* PHILADELPHIA STOCK EXCHANGE, *SEEING WITH THE EYE OF IMAGINATION* 8 (1988).

33. GAO STAFF STUDY, *supra* note 17, at 70.

34. *Id.* CFTC Rule 1.38 requires competitive bidding in all futures transactions unless the Commission approves the non-competitive execution of the transaction. 17 C.F.R. § 1.38 (1991).

35. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.04. Once the original trade is completed, the traders owe their obligations to the clearinghouse, not to the party with whom they traded. *See also* Chicago Mercantile Exchange v. S.E.C., 883 F.2d 537, 546 (7th Cir. 1989) (futures contracts settled by offsetting obligations which are cancelled by clearing house), *cert. denied*, American Stock Exchange, Inc., v. Chicago Mercantile Exchange, 110 S. Ct. 3214 (1990).

36. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.04.

37. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982) (noting federal government regulation of commodities futures since 1921).

38. 15 U.S.C. §§ 78a-78kk (1988).

39. *Mallen v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 605 F. Supp. 1105, 1108 (N.D. Ga. 1985) (rejecting state and federal securities law claims of stock index futures investor); *see also* Schneider & Schapiro, *supra* note 2, at 78 (CFTC patterned after SEC).

entire commodity futures industry.⁴⁰ The CFTC's jurisdiction was even broader than anticipated because the amendments enlarged the definition of a commodity beyond traditional agricultural products⁴¹ and included a clause giving the CFTC exclusive jurisdiction over any product having the elements of a futures contract.⁴² The exclusivity clause, as it is known, has led to much of the conflict between the SEC and the CFTC.⁴³

D. Commodity Futures Trading Commission

The CFTC was created in 1974 for the purpose of "protect[ing] the public from fraud and manipulation in the [futures] marketplace."⁴⁴ The CFTC has jurisdiction over all futures contract transactions but does not have regulatory authority over the underlying commodities.⁴⁵ Thus, while the CFTC was created in response to agricultural crises, its regulatory impact on the agricultural economy is tangential at best.⁴⁶ The CFTC exercises its regulatory authority principally by overseeing the efforts of self-regulatory organizations such as the futures exchanges

40. Schneider & Schapiro, *supra* note 2, at 78. The CFTC was created pursuant to § 4a(a)(1) of the Commodities Exchange Act. 7 U.S.C. § 4a(a)(1) (1988).

41. The expanded definition of a commodity includes "all other goods and articles . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt." 7 U.S.C. § 2 (1988). For the full definition of a commodity, see *supra* note 17. Commenting on the expanded definition of commodity, the *Mallen* court stated that the "act . . . perhaps too broadly, expanded the concept of a commodity from the edible to the intangible." *Mallen*, 605 F. Supp. at 1108.

42. 7 U.S.C. § 2 (1988). The exclusivity clause reads:

Provided, That the Commission [CFTC] shall have exclusive jurisdiction, except to the extent otherwise provided . . . with respect to . . . transactions involving contracts of a commodity for future delivery, traded or executed on a contract market . . . *And provided further*, That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws.

Id.

43. See, e.g., *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537 (7th Cir. 1989) (index participations within exclusive jurisdiction of CFTC), *cert. denied*, 110 U.S. 3214 (1990).

44. GAO STAFF STUDY, *supra* note 17, at 9.

45. See *Financial Market Hearings*, *supra* note 7, at 355. CFTC Chairperson Wendy Gramm testified that "[w]e regulate futures in general . . . [w]e do not regulate the oil markets, we do not regulate the wheat and corn, we regulate the futures markets." *Id.*

46. See GAO STAFF STUDY, *supra* note 17, at 64. Most farmers sell their crops by use of forward contracts that are exempt from the CFTC's jurisdiction. See 7 U.S.C. § 2 (1988).

and the National Futures Association,⁴⁷ an organization patterned after the National Association of Securities Dealers.⁴⁸ This system of regulation was patterned after that of the SEC and the securities industry.⁴⁹

The CFTC consists of five commissioners, one of whom is the chairman, appointed for five year terms by the President, subject to Senate confirmation.⁵⁰ The CFTC is organized into three major divisions: Trading and Markets (responsible for market regulation), Enforcement (responsible for investigation of alleged violations of the provisions of the CEA and CFTC rules) and Economic Analysis (responsible for review of trading activities).⁵¹ Although the CFTC as a whole was patterned after the SEC, the Division of Economic Analysis performs a function unique to the CFTC in that it analyzes all proposed futures contracts to ensure that each contract has a valid economic purpose.⁵² The SEC, on the other hand, takes the view that it is not the guarantor of a security's economic viability.⁵³

III. THE SEC AND THE SECURITIES INDUSTRY

A. *Securities*

The Securities Exchange Act of 1934 defines a security as:

any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or

47. GAO STAFF STUDY, *supra* note 17, at 70, 76.

48. 1 P. JOHNSON AND T. HAZEN, *supra* note 18, § 1.89; *see also* GAO STAFF STUDY, *supra* note 17, at 68.

49. Schneider & Schapiro, *supra* note 2, at 78. The major divisions of the CFTC, with the exception of the Division of Economic Analysis, are the functional equivalents of the major SEC divisions. *Id.* For a further discussion of the organizational structure of the CFTC, *see infra* notes 50-51 and accompanying text. For a further discussion of the SEC, *see infra* notes 74-78 and accompanying text. For a discussion of the major difference between the agencies, *see infra* notes 52-53 & 79-80 and accompanying text.

50. 7 U.S.C. § 4a(a)(1) (1988); *see also* 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.80. The House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry oversee the CFTC.

51. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.80. The CFTC has approximately 500 staff members working in its Washington headquarters and four regional offices. GAO STAFF STUDY, *supra* note 17, at 9.

52. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.80; *see also* 7 U.S.C. § 4 (1988).

53. SECURITIES AND EXCHANGE COMMISSION, THE WORK OF THE SEC 4 (1986) [hereinafter WORK OF THE SEC] (role of securities regulation is full disclosure which enables investors to make their own decisions as to value).

group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing⁵⁴

Securities have two principal purposes. First, securities are one of the primary means of raising business capital.⁵⁵ Second, securities are a vehicle by which investors can earn profits from another's efforts.⁵⁶

B. Securities Markets

Securities markets have two major functions. First, securities markets serve as a forum for the formation of business capital through the sale of a corporation's securities.⁵⁷ Second, securities markets provide a

54. 15 U.S.C. § 78c(a)(10) (1988). The definition of security mentions certain forms of securities by name, such as "stock," "bond" and "debenture." *Id.* In addition, the definition provides several generic categories, such as "investment contract," "certificates of interest or participation" and "any instrument commonly known as a 'security,'" which may be used to bring novel financial instruments within the scope of the federal securities laws. *Id.* For example, the Chicago Board Options Exchange argued that its GNMA options were securities under the "warrant or rights to subscribe to or purchase" clause, the "investment contract" clause or the "commonly known as a security" clause of the statutory definition. *Board of Trade v. S.E.C.*, 677 F.2d 1137, 1156-58 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). For a further discussion of *Board of Trade*, see *infra* notes 93-99 and accompanying text.

55. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 543 (7th Cir. 1989), *cert. denied*, 110 U.S. 3214 (1990). In contrast, the fundamental purposes of futures transactions are price discovery and hedging. *Id.* For a discussion of the similarity between securities and futures transactions, see *infra* notes 250-74 and accompanying text.

56. *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946). In *Howey*, the security involved was a combination land sale and service contract which entitled the purchaser to a portion of a Florida orange grove plus the company's professional services in cultivating, harvesting and marketing the resulting crop. *Id.* at 295. The Supreme Court held that the contracts constituted an investment contract because the purchasers "invest[ed] [their] money in a common enterprise and [were] led to expect profits solely from the efforts of the promoter or a third party." *Id.* at 298-300.

57. *Chicago Mercantile*, 883 F.2d at 543. New issues of securities, however, particularly those of new ventures, rarely trade on the New York Stock Exchange or similar exchanges. R. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS* 417 (1989). Most initial offerings of new ventures are conducted by brokerage houses contacting established customers. *Id.*; see also, *Financial Market Hearings*, *supra* note 7, at 436 (testimony of Leo Melamed, Chairman of Chicago Mercantile Exchange). Chairman Melamed argued that the New York Stock Exchange does not directly support capital formation because few new issues are traded on the exchange. He testified, however, that stock index futures indirectly encourage capital formation by "transferring the risk of a stock portfolio, and by

ready forum for the resale of securities by investors.⁵⁸ The ability to resell in a liquid market is one of the most important reasons investors participate in the securities markets, thereby aiding the formation of capital.⁵⁹ Securities such as options, which are issued by persons rather than corporations, also improve liquidity and aid capital formation.⁶⁰

Securities are presently sold on nine exchanges,⁶¹ with the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) being the largest and most prominent.⁶² In contrast to futures, which must be sold on a registered futures exchange, securities may be sold away from an exchange, either on the National Association of Securities Dealers Automatic Quotation System (NASDAQ) or through a broker-oriented network known as the over-the-counter market.⁶³ In fact, NASDAQ is the second largest securities market in the United States and the third largest in the world.⁶⁴ Securities may also be sold in a variety of transactions that are exempt from federal regulation, such as

providing liquidity for 'baskets' of stock. " *Financial Market Hearings*, *supra* note 7, at 437.

58. GAO STAFF STUDY, *supra* note 17, at 22. Providing a forum for investor resale is perhaps the most significant feature of the larger exchanges such as the New York Stock Exchange. R. HAMILTON, *supra* note 57, at 417; *see also Financial Market Hearings*, *supra* note 7, at 436-37 (testimony of Leo Melamed, Chairman of Chicago Mercantile Exchange) (real role of New York Stock Exchange is to provide liquidity to shareholders).

59. GAO STAFF STUDY, *supra* note 17, at 22.

60. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMMODITY FUTURES COMM'N & SECURITIES AND EXCHANGE COMM'N, A STUDY ON THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS I-2 (1985) (presented to the House Committee on Agriculture, 98th Cong., 2d Sess.). The futures industry claims that stock index futures also improve liquidity in the securities markets and indirectly aid capital formation. *Financial Market Hearings*, *supra* note 7, at 437 (testimony of Leo Melamed, Chairman of Chicago Mercantile Exchange).

61. GAO STAFF STUDY, *supra* note 17, at 8. Securities are presently sold on the New York Stock Exchange, American Stock Exchange, Chicago Board Options Exchange, Boston Stock Exchange, Midwest Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange and Spokane Stock Exchange. *Id.* at 8 n.1.

62. *Id.* at 11. Ninety percent of all securities transactions occur on the New York and American Stock Exchanges or over the NASDAQ quotation system. *Id.*

63. *Id.* at 8.

64. *The Market Reform Act of 1989: Hearings Before the Subcomm. on Securities and the Senate Comm. on Banking, Housing, and Urban Affairs on S. 648*, 101st Cong., 1st Sess. 61 (1989) [hereinafter *Market Reform Hearings*] (testimony of Joseph Hardiman, President of the National Association of Securities Dealers). The House compromise version of the Market Reform Act was signed into law on October 16, 1990. *President Signs Major New Laws on Enforcement Remedies, Market Reform*, 22 Sec. Reg. & L. Rep. (BNA) No. 41, at 1475 (Oct. 19, 1990). The Act gives the SEC the authority to close securities markets during emergencies, restrain program trading during periods of market volatility and collect information on large traders. *Id.*

private placements and intrastate offerings.⁶⁵

The form of securities trading varies depending on the location of the trade. On the securities exchanges, like the futures exchanges, trading occurs in specially-designated areas by competitive, auction-like bidding between traders.⁶⁶ Specialists, brokers who specialize in the trading of a certain security, step into the fray whenever necessary to ensure a fair and orderly market.⁶⁷ In the off-exchange markets, however, brokers contact market makers, other brokers who guarantee that they will trade in a specified security, and negotiate the best deal possible for their customers.⁶⁸

C. Securities and Exchange Commission

Federal regulation of the securities industry was prompted by the stock market crash of 1929.⁶⁹ In 1933, Congress passed the Securities Act, which required the registration of most securities and the disclosure of detailed information concerning the entities issuing the securities.⁷⁰ One year later, in the Securities Exchange Act of 1934, Congress created the SEC, an independent, quasi-judicial regulatory agency.⁷¹ Congress charged the SEC with the responsibility of "protect[ing] the public from fraud and abuses in the securities markets."⁷² The SEC exercises

65. 15 U.S.C. §§ 77d(2), 77c(a)(11) (1988). A private placement is an offering of a security which does not involve a public offering. 15 U.S.C. § 77d(2) (1988). In Regulation D of the Securities Act of 1933, the SEC has provided three "safe-harbor" rules, Rules 504 to 506, for issuers desiring to conduct private offerings. 17 C.F.R. § 230.501-.508 (1991). Rules 505 and 506 both prohibit the sale of the exempt security to more than 35 nonaccredited investors. 17 C.F.R. §§ 230.505(b)(2)(ii), 506(b)(2)(i).

An intrastate offering is an offering in which all offerees are residents of the state in which the issuer is resident and doing business. See 15 U.S.C. § 77c(a)(11) (1988). Rule 147 serves as a safe-harbor for issuers conducting an intrastate offering. 17 C.F.R. § 230.147 (1991).

66. GAO STAFF STUDY, *supra* note 17, at 23. For a discussion of futures exchanges and the form of futures transactions, see *supra* notes 30-36 and accompanying text.

67. R. HAMILTON, *supra* note 57, at 424. The role of a specialist is to "let the market find its proper level, given the supply and demand for the stock that then exists" but not to "try to prevent market declines." *Id.* Nevertheless, many commentators have focused on the specialist system as one of the major contributors to the 1987 market break. SECURITIES AND EXCHANGE COMM'N, DIVISION OF MARKET REGULATION, THE OCTOBER 1987 MARKET BREAK 4-1 to 4-72 (1988) [hereinafter SEC CRASH REPORT], reprinted in [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,118 (Feb. 1988).

68. R. HAMILTON, *supra* note 57, at 436.

69. GAO STAFF STUDY, *supra* note 17, at 27.

70. WORK OF THE SEC, *supra* note 53, at 5-8.

71. *Id.* at 3. The SEC was created pursuant to § 4 of the Securities Exchange Act. 15 U.S.C. § 78d(a) (1988). The Federal Trade Commission administered the Securities Act of 1933 before the SEC was created. R. JENNINGS & H. MARSH, SECURITIES REGULATION CASES AND MATERIALS 479 (6th ed. 1987).

72. GAO STAFF STUDY, *supra* note 17, at 9.

its regulatory authority principally by overseeing the efforts of self-regulatory organizations such as the securities exchanges and the National Association of Securities Dealers.⁷³

The SEC consists of five commissioners appointed for five year terms by the President with the advice and consent of the Senate.⁷⁴ The SEC is organized into four primary divisions: Corporation Finance (responsible for the adequacy of disclosure materials); Market Regulation (responsible for overseeing the participants and the activity in the secondary markets); Investment Management (responsible for administering the Investment Company Act,⁷⁵ the Investment Advisers Act⁷⁶ and the Public Utility Holding Company Act⁷⁷) and Enforcement (responsible for enforcing the federal securities laws).⁷⁸ Unlike the CFTC, the SEC does not analyze securities offerings for economic viability.⁷⁹ The premise behind federal securities regulation is that, with adequate information, an investor can make individual judgments concerning a security's value.⁸⁰

IV. HISTORY OF JURISDICTIONAL DISPUTES

A. Introduction

The history of disputes between the SEC and the CFTC dates back to the very dawn of the CFTC's existence. The CFTC officially commenced operations on April 30, 1975.⁸¹ On February 14, 1975, the SEC, fearful that the Commodity Exchange Act's exclusivity clause would preempt SEC jurisdiction over stock options, proposed an

73. *Id.* at 37. This regulatory scheme was proposed by the Roper Commission, a presidential commission charged with investigating the 1929 crash. *Id.* at 27.

74. WORK OF THE SEC, *supra* note 53, at 3.

75. 15 U.S.C. §§ 80a-1 to -2 (1988). The Investment Company Act regulates mutual funds and other forms of investment companies in which investors pool their assets under the professional management of the fund. T. HAZEN, THE LAW OF SECURITIES REGULATION 566-67 (1985).

76. 15 U.S.C. §§ 80b-1 to -2 (1988). The Investment Advisers Act regulates professionals who render investment advice but do not fall within the broker-dealer regulations under the Securities Exchange Act. T. HAZEN, *supra* note 75, at 626 n.2.

77. 15 U.S.C. §§ 79 to 79z-6 (1988). "The Public Utility Holding Company Act regulates holding companies with subsidiaries which are public utilities." T. HAZEN, *supra* note 75, at 534.

78. WORK OF THE SEC, *supra* note 53, at 24-36. The commissioners are supported by a staff of over 2,000 persons located in the SEC's Washington, D.C. headquarters, regional offices located in New York, Boston, Atlanta, Chicago, Fort Worth, Denver, Los Angeles, Seattle and Philadelphia and branch offices in Miami, Detroit, Houston, Salt Lake City and San Francisco. *Id.* at 38-40; *see also* GAO STAFF STUDY, *supra* note 17, at 9.

79. For a further discussion of the CFTC's economic analysis, *see supra* notes 45-46.

80. WORK OF THE SEC, *supra* note 53, at 4.

81. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.80.

amendment to the Securities Exchange Act which would give the SEC exclusive jurisdiction over all "transactions involving a 'security.'"⁸² Thus, the battle over jurisdiction began even before the CFTC officially commenced operations. The battle did not escalate, however, until 1981, when the SEC approved the application of the Chicago Board Options Exchange to trade options on GNMA mortgage certificates.⁸³

B. The Fight for "Ginnie Mae"

1. Products Based on GNMA Certificates

The Government National Mortgage Association established the GNMA certificate program to secure new funds for government-backed mortgage programs.⁸⁴ The holder of a GNMA certificate, a "Ginnie Mae," was entitled to receive a portion of the income generated by the mortgage program.⁸⁵ GNMA certificates paid a fixed rate of interest, so the value of the investment depended on the level of outside interest rates.⁸⁶ Accordingly, derivative products, GNMA options and futures, were created to transfer the risk of adverse interest rate fluctuations from the certificate holders to speculators.⁸⁷

The Chicago Board of Trade began trading in GNMA futures, contracts for the future delivery of GNMA certificates at a fixed price, in 1975.⁸⁸ Like most futures, the GNMA futures were ordinarily extinguished through offset or cash settlement, not delivery.⁸⁹ In 1981, the Chicago Board Options Exchange (CBOE) began trading in GNMA options.⁹⁰ The options entitled the holder to buy or sell GNMA certificates at a set price before a certain date.⁹¹ The CBOT brought suit in 1981 challenging the SEC approval of a rule that would have permitted the CBOE to trade GNMA options on the grounds that the CFTC had

82. Board of Trade v. SEC, 677 F.2d 1137, 1149 (7th Cir.) (quoting *Hearings Before the Senate Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs on S. 249*, 94th Cong., 1st Sess. 244 (1975)), *vacated as moot*, 459 U.S. 1026 (1982).

83. *Id.* at 1138.

84. *Id.* at 1138-39.

85. *Id.* at 1139.

86. *Id.* An investor would recognize a profit from a GNMA investment if outside interest rates remained below those paid on the GNMA certificates. *Id.*

87. *Id.* For a discussion of the general role of futures in transactions such as this one, see *supra* text accompanying notes 24-29.

88. Board of Trade, 677 F.2d at 1152-53.

89. *Id.* For a discussion of the practice of offset and cash settlement in futures transactions, see *supra* notes 22-23 and accompanying text.

90. Board of Trade, 677 F.2d at 1139.

91. *Id.* GNMA options differed from GNMA futures in that the owner of a GNMA option had the right, but not the obligation, to purchase or sell the GNMA certificate on or before the expiration date, while the owner of a GNMA future was obligated to purchase or sell the GNMA certificate or extinguish his position through offset or cash settlement on or before the expiration date. *Id.*

exclusive jurisdiction over the options.⁹²

2. Board of Trade of Chicago v. Securities and Exchange Commission

In *Board of Trade of Chicago v. Securities and Exchange Commission*,⁹³ the United States Court of Appeals for the Seventh Circuit agreed with the CBOT, holding that the CFTC had exclusive jurisdiction over GNMA options and imposing a ban on GNMA options trading.⁹⁴ The *Board of Trade* court first held that GNMA options were, in essence, futures contracts because the options had the characteristics of a "legitimate commodity derivative."⁹⁵ The court then rejected the assertions of the SEC and CBOE that GNMA options were securities under the "warrants or rights to subscribe to or purchase" securities clause,⁹⁶ the "investment contract" clause⁹⁷ or the "commonly known as securities" clause of section 3(a)(10) of the Securities Exchange Act.⁹⁸ Thus, the court instructed that even though "the CFTC exclusive jurisdiction clause must have some limits," options on GNMA certificates fell within those limits.⁹⁹

3. Jurisdictional Accord

In 1982, in response to the ever-widening rift between their agencies, Phillip Johnson, Chairman of the CFTC, and John Shad, Chairman of the SEC, negotiated a deal that purported to settle the jurisdictional dispute.¹⁰⁰ Under the terms of the agreement, known as the John-

92. *Id.* at 1140-41.

93. 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982).

94. *Id.* at 1153, 1161 n.49 ("[W]hile we wait for the CFTC to follow procedures set out in CEA § 4c(c), GNMA options are to be *banned*.").

95. *Id.* at 1152-53. In making its determination, the court relied on the fact that the GNMA option was based on a commodity and served "legitimate hedging and price discovery functions, thereby facilitating production of the underlying commodity." *Id.* at 1151. The court subsequently opined, however, that the GNMA certificate was a security. *Id.* at 1155. The court then qualified this statement by stating that "we shall assume without deciding that GNMA's are securities." *Id.* at 1156 n.36.

96. *Id.* at 1156-57. The court distinguished traditional options to buy stock from GNMA options, holding that GNMA options were not options to buy securities. *Id.* at 1156-57 & 1156 n.37.

97. *Id.* at 1157-58. The GNMA options could not be an investment contract because of the court's earlier finding that they were futures. *Id.* According to the court, commodity futures are not investment contract securities. *Id.* at 1158.

98. *Id.* The court, citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975), stated that the analysis was the same for an "instrument commonly known as a 'security' " and an "investment contract." *Board of Trade*, 677 F.2d at 1158. For the text of § 3(a)(10) of the Securities Exchange Act of 1934, see *supra* text accompanying note 54.

99. See *Board of Trade*, 677 F.2d at 1147-48.

100. Schick, *supra* note 6, at 61.

son/Shad or Shad/Johnson Accord depending on the speaker's allegiance, the CFTC was to have exclusive jurisdiction over all futures contracts, options on futures, stock index futures and options on stock index futures, while the SEC was to have authority over options on securities and options on stock indices.¹⁰¹ The agreement was subsequently codified as amendments to the Commodities Exchange Act and the Securities Exchange Act.¹⁰² Although the accord has settled jurisdictional issues as to the stated instruments, it is incapable of addressing new instruments such as stock index participations.¹⁰³

C. *The Battle Over Index Participations*

1. *Index Participations*

In the late 1980s, securities exchanges developed index participations (IPs) as a means for investors to "buy the market" without enduring the time and expense of buying a broad range of stocks.¹⁰⁴ The development of IPs was hastened by studies recommending the trading of baskets of stock as a means of preventing future stock market crashes.¹⁰⁵

The Philadelphia Stock Exchange, one of three exchanges offering IPs,¹⁰⁶ developed two IPs, called Cash Index Participations or CIPs. The Standard & Poor's (S&P's) 500 CIP was based on the S&P's 500 Index and represented one-tenth of the index's value.¹⁰⁷ The Blue Chip CIP was based on a price-weighted index of twenty-five blue chip stocks and represented one-hundredth of the underlying index's value.¹⁰⁸

101. SECURITIES AND EXCHANGE COMMISSION & COMMODITIES FUTURES TRADING COMMISSION, JOINT EXPLANATORY STATEMENT, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21, 332 (Feb. 2, 1982) (setting forth terms of Johnson/Shad Accord).

102. Pub. L. No. 97-303, 96 Stat. 1409 (1982); Pub. L. No. 97-444, 96 Stat. 2294 (1983) (both codified in scattered sections of 7 U.S.C. and 15 U.S.C. (1988)).

103. See *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 539 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 3214 (1990). The *Chicago Mercantile* court stated that "newfangled instruments may have aspects of each of the prototypes. Our case is about such an instrument, the index participation (IP). We must decide whether tetrahedrons belong in square or round holes." *Id.*

104. PHILADELPHIA STOCK EXCHANGE, THE POWER OF SIMPLICITY CASH INDEX PARTICIPATIONS FROM THE PHILADELPHIA STOCK EXCHANGE 4-5 (1988) [hereinafter *POWER OF SIMPLICITY*].

105. *Id.*

106. *Chicago Mercantile*, 883 F.2d at 540. The American Stock Exchange offered an IP called the Equity Index Participation (EIP), while the Chicago Board Options Exchange offered an IP called the Value of Index Participation (VIP). *Id.* The EIP differed from the CIP in that holders of 500 EIP units could receive shares of stock when cashing-out their positions. *Id.* The VIP differed from the other products in that it had a semi-annual cash-out and the short could cash-out by tendering the value of the underlying index on the cash-out date. *Id.*

107. *POWER OF SIMPLICITY*, *supra* note 104, at 6.

108. *Id.* at 7.

Trading occurred in round lots of 100 CIP units.¹⁰⁹ The CIP's value would increase or decrease in correlation with the underlying index's value. In addition, the CIP paid all dividends declared on the stock in the underlying index.¹¹⁰

CIPs were designed to be permanent instruments with no expiration date.¹¹¹ The CIP owner could, however, "cash-out," sell his position on a specified quarterly date or on any other day, incurring only a small penalty.¹¹² The owner could also cash-out through offset, taking the opposite position in a different, but identical contract.¹¹³ These features were intended to give small investors "a permanent stake in the market without being subject to the time constraints that exist in index futures and options products."¹¹⁴ For this reason, CIPs were generally hailed as desirable, worthwhile products.¹¹⁵

2. Chicago Mercantile Exchange v. Securities and Exchange Commission

In 1989, the CME and CBOT brought suit in federal court challenging the SEC's approval of IP trading on the Philadelphia and American

109. *Id.* at 9. For example, if the S&P Index was valued at 250, the price of a single CIP unit would be \$25, and a single round lot purchase would cost \$2500. *Id.* at 6-7.

110. *Id.* at 3. By paying the dividends that the underlying stocks were paying, the Philadelphia Stock Exchange was clearly attempting to infuse characteristics of a security into the CIP, and therefore differentiate it from an index future and preserve the SEC's jurisdiction over the product. *Id.*

111. *Id.* The lack of an expiration date is a clear attempt to differentiate the CIP from an index future. *Id.*

112. *Id.* at 10. The penalty equaled one-half of one percent of the CIP's value. *Id.* The Philadelphia Stock Exchange argued that the CIP was not a futures contract because the daily cash-out provision eliminated the element of futurity. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 550 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 3214 (1990).

113. POWER OF SIMPLICITY, *supra* note 104, at 10. Unfortunately for the Philadelphia Stock Exchange, the offset potential gave the CIP one of the characteristics of a future. *Chicago Mercantile*, 883 F.2d at 546.

114. POWER OF SIMPLICITY, *supra* note 104, at 5.

115. *Market Reform Hearings*, *supra* note 64, at 132 (statement of Senator John Heinz). Senator Heinz stated that

when you have got a product that has, if you will, gotten a repeated Good Housekeeping seal of approval and that the goal of the product, as established by study after study, is to make the markets less volatile, enhance investor confidence, bring those small investors back into the market who as of 1988 constituted all of 18.5 percent of the trading volume, it seems to me there ought to be a way of getting that product into the marketplace that doesn't rely on an interminable—and I do mean interminable—series of court proceedings, appeals, reappeals that has the net effect, whether you mean or not, to keep that product out.

Id.

Stock Exchanges and the Chicago Board Options Exchange.¹¹⁶ In the course of the authorization hearings before the SEC, the CFTC and the futures exchanges argued that IPs were futures within the CFTC's jurisdiction and urged the SEC not to approve IPs for trading on the securities exchanges.¹¹⁷ The SEC, however, found that IPs were securities and approved their trading.¹¹⁸

In *Chicago Mercantile Exchange v. Securities and Exchange Commission*,¹¹⁹ the Seventh Circuit sided, as in *Board of Trade*, with the CFTC and the futures exchanges, holding that IPs fell within the CEA's exclusivity clause and could not, therefore, be traded on the securities exchanges.¹²⁰ The *Chicago Mercantile* court noted that while "the SEC found IPs to be securities by looking at the promises made to the longs [dividends, daily cash-outs and no expiration], the CFTC found them to be futures by virtue of the promises made by the shorts [quarterly cash-outs and value dependent on future events]."¹²¹ The court further stated that an IP is "no less a future than it is a security, and no more. It just doesn't fit. Which is the whole point. It isn't supposed to be like something else; the IP was designed as a novel instrument so that it could offer attributes previously missing in the market."¹²² The court concluded, however, that because the IP had some elements of a future, it fell within the CFTC's jurisdiction under the exclusivity clause and could not be traded on securities exchanges.¹²³ The court observed that in the case of innovative derivative products, "[o]nly merger of the agencies or functional separation in the statute can avoid continual conflict."¹²⁴

D. Escalation

The jurisdictional dispute between the SEC and the CFTC reached new levels of intensity after the stock market break in 1987, but it was not until the Seventh Circuit's decision in *Chicago Mercantile* that the

116. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 3214 (1990).

117. *Id.* at 539.

118. *Id.* at 540. The SEC concluded that IPs were securities as either "stock," because "they pay dividends, may appreciate in value and may be hypothecated," or "certificates of interest or participation in" stock. *Id.* For the complete text of the definition of security under the Securities Exchange Act of 1934, see text accompanying note 54. The SEC also concluded that IPs were not futures contracts because IPs lacked the elements of futurity and bilateralism. *Chicago Mercantile*, 883 F.2d at 541.

119. 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 3214 (1990).

120. *Id.* at 550 ("[T]he SEC's order approving the applications of the stock exchanges and the OCC [to trade IPs] are set aside.").

121. *Id.* at 545-46 (emphasis omitted).

122. *Id.* at 546.

123. *Id.* at 548-50.

124. *Id.* at 544.

agencies engaged in open hostility.¹²⁵ Recently, the SEC has aggressively advocated a merger of the agencies while the CFTC has fought for its very existence.¹²⁶ The ever-escalating conflict has drawn the attention of several prominent congressmen and administration officials, one of whom described the conduct of the agencies' chairmen as "juvenile."¹²⁷ The following section contains a discussion of several recent proposals for ending the jurisdictional disputes.

V. RECENT PROPOSALS

A. Introduction

The recent proposals for ending the jurisdictional conflict between the SEC and the CFTC generally can be placed into three camps: those calling for the retention of the present jurisdictional scheme,¹²⁸ those advocating SEC jurisdiction over any product based on a securities index¹²⁹ and those demanding a total merger or consolidation of the agencies.¹³⁰ Within the federal government, the CFTC opposes both a merger and a jurisdictional shift, while the SEC and the Treasury Department advocate a merger of the agencies.¹³¹ The Federal Reserve Board opposes a merger and has no official opinion on the subject of a jurisdictional realignment; but, Chairman Alan Greenspan supports a jurisdictional realignment while opposing a total merger, a position apparently supported by President Bush.¹³²

125. See, e.g., *Financial Market Hearings*, *supra* note 7, at 353-55 (committee questions concerning jurisdiction directed at chairmen of SEC and CFTC).

126. See, e.g., *SEC, Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990); *Shift of Index Products to SEC Would Weaken CFTC, Gramm Contends*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 481 (Mar. 30, 1990) (CFTC opposition to jurisdictional realignment).

127. *Brady Rules Out Any Compromise on SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA) No. 28, at 1031 (July 13, 1990) (statement of Treasury Secretary Nicholas Brady).

128. For a discussion of the proposal to retain the present jurisdictional system, see *infra* notes 133-37 and accompanying text.

129. For a discussion of the proposal to realign the jurisdiction of the agencies, see *infra* notes 138-45 and accompanying text.

130. For a discussion of the proposal to merge the agencies, see *infra* notes 146-47 and accompanying text. For support of a proposal to consolidate the agencies, see *infra* notes 148-302 and accompanying text.

131. *SEC, Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990).

132. *Id.* Support for the CFTC's position has not been unanimous, however. Present Commissioner William Albrecht has stated that the Jurisdictional Accord needs to be updated to "permit[] and encourage[] competition within the futures industry, within the securities industry and between the two industries." *CFTC's Albrecht says SEC-CFTC Jurisdictional Accord Needs Change*, 22 Sec. Reg. & L. Rep. (BNA) No. 5, at 141-42 (Jan. 26, 1990). Furthermore, former CFTC Commissioner James Stone has advocated a merger of the agencies since 1982. GENERAL ACCOUNTING OFFICE, PRELIMINARY REPORT TO CONGRESS ON THE

B. Retention of Present Jurisdictional Structure

Basically, the only parties advocating a retention of the present jurisdictional structure are the CFTC, the Senators and Representatives on the agriculture committees, and the futures industry itself.¹³³ The basic argument against any change is that the present jurisdictional structure is necessary to protect agricultural interests¹³⁴ and to foster innovation and competition among the exchanges.¹³⁵ In addition, the CFTC argues that a jurisdictional realignment would result in "confusion and excess regulation and jeopardize the U.S. futures industry's preeminence in world financial markets."¹³⁶ In an effort to retain the present jurisdictional scheme, Senator Alan Dixon (D-Ill.) introduced a bill that would create full voting cross-memberships in each agency.¹³⁷

C. Jurisdictional Realignment

The proposal receiving the most broad-based support is one that would shift jurisdiction over products based on a securities index to the

STOCK MARKET CRASH OF 1987, at 28 [hereinafter GAO CRASH REPORT], reprinted in Comm. Fut. L. Rep. (CCH) No. 322 (Feb. 11, 1988) (special separately bound volume).

133. *Shift of Index Products to SEC Would Weaken CFTC*, Gramm Contends, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 481 (Mar. 30, 1990). For a further discussion of the futures industry's effects on the agricultural community, see *supra* notes 18 & 28 and accompanying text.

134. *SEC, Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990) (statement of Senator Phil Gramm). Senator Gramm's statements about competition among exchanges appear to be misguided, however. In *Board of Trade v. S.E.C.*, 883 F.2d 525, 532 (7th Cir. 1989), cert. denied, 110 S. Ct. 3214 (1990), the court noted that

[f]utures markets benefit from exclusivity; [securities] trading reduces the volume of futures trading, and competition doubtless reduces the commissions as well. Investors, on the other hand, gain from the competition the futures markets dislike. Indeed, unless the creation of a new means of trading benefits investors (by introducing new financial instruments or driving down the price of trading) the futures markets won't file suit.

Id. For a further discussion of the impact of the jurisdictional disputes on financial innovation, see *infra* notes 235-47 and accompanying text.

135. *Financial Market Hearings*, *supra* note 7, at 369 (testimony of Wendy Gramm, Chairperson, CFTC).

136. *Shift of Index Products to SEC Would Weaken CFTC*, Gramm Contends, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 481 (Mar. 30, 1990).

137. *Id.* Senator Dixon's bill was designated S. 2335. *Id.* Cross-membership would mean that a member of the CFTC would become a full voting member of the SEC, and a member of the SEC would become a full voting member of the CFTC. *Id.* In another attempt to retain the present jurisdictional alignment, on February 19, 1991, the House Agriculture Conservation Subcommittee approved a bill (H.R. 707) that would give the CFTC permanent status with no changes in its present jurisdiction. *House Panel Approves Bill to Give CFTC Permanent Status, Ban Dual Trading*, 23 Sec. Reg. & L. Rep. (BNA) No. 8, at 301 (Feb. 22, 1991).

SEC.¹³⁸ Under this proposal, stock index futures and options on stock index futures would be regulated by the SEC while the CFTC would retain jurisdiction over futures on traditional commodities.¹³⁹ The argument in favor of this proposal is two-pronged. First, it has been argued that the SEC should have jurisdiction over any product related to the securities markets, particularly those products that have the potential of exerting a great deal of pressure on securities prices.¹⁴⁰ Second, it has been argued that the CFTC should retain jurisdiction over traditional commodity-based products, because that is the area in which it has the greater experience and because "nonfinancial futures do not affect other financial markets in the same manner as stock derivative instruments."¹⁴¹

In June 1990, the Treasury Department submitted to Congress a bill entitled the "Capital Markets Competition, Stability, and Fairness Act of 1990,"¹⁴² which would shift regulation of stock index futures to the SEC, modify the CEA's exclusivity clause, overturn the *Chicago Mercantile* decision and give the CFTC power to exempt currency and interest rate swap agreements from CFTC regulation.¹⁴³ The bill, tied to the CFTC reauthorization bill,¹⁴⁴ did not receive enough support for floor consideration and was killed during the 1990 session of Congress.¹⁴⁵

138. See *Financial Market Hearings*, *supra* note 7, at 554-55 (position of Dean Witter Financial Services), 560 (position of Rodney & Co.), and 571 (position of Securities Industry Association); *SEC, Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990) (proposal supported by SEC, Treasury Department and Federal Reserve Board Chairman Alan Greenspan); Schick, *supra* note 6, at 63 (supporting shift to SEC).

139. Schick, *supra* note 6, at 63-64.

140. *Id.*; see also *Financial Market Hearings*, *supra* note 7, at 258 (statement of David Ruder, Chairman, SEC) ("Neither as a matter of regulatory efficiency nor as a matter of public confidence does it make sense to maintain separate authority over the stock index futures and the stock markets.").

141. Schick, *supra* note 6, at 64.

142. *Treasury Submits Bill to Give SEC Jurisdiction Over Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 23, at 859 (June 8, 1990).

143. *Id.*

144. *Senators Fail in Last-Minute Effort to Resolve SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA) No. 41, at 1476-77 (Oct. 19, 1990). The CFTC reauthorization bill was designated S. 1729. *Id.* at 1477. For a further discussion of this bill, see *infra* note 246 and accompanying text.

145. *Senators Fail in Last-Minute Effort to Resolve SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA) No. 41, at 1477 (Oct. 19, 1990) (bill failed because of lack of support for proposal requiring SEC and CFTC to share jurisdiction over index futures). In 1991, Senator Patrick Leahy (D-Vt.) introduced a bill (S. 207) that would force the CFTC and the SEC to share jurisdiction over any instrument that has characteristics of both a future and a security. Any such instrument could be traded on either a securities or futures exchange. The bill did not, however, completely strip the CFTC of jurisdiction over hybrid instruments as did the 1990 Treasury Department bill. *CFTC Reauthorization Bill Introduced, SEC Would Share Jurisdiction With CFTC*, 23 Sec. Reg. & L. Rep. (BNA) No. 24, at 126 (Jan. 25, 1991).

D. *Merger of the Agencies*

Perhaps the most controversial proposal is the total merger or consolidation of the agencies. Even some of the most ardent supporters of a jurisdictional realignment have spoken out against a complete merger, arguing, for example, that it could stifle innovation.¹⁴⁶ Nevertheless, in 1990, Representatives Dan Glickman (D-Kan.) and Dennis Eckard (D-Ohio) introduced a bill that would merge the two agencies into a single entity.¹⁴⁷

VI. SUPPORT FOR A CFTC/SEC CONSOLIDATION

A. *Introduction*

It is submitted that Congress should consolidate the CFTC and the SEC into a single regulatory agency in order to end the jurisdictional disputes between the agencies and to effectively address the problems now facing the securities, futures and hybrid industries. The factors pointing to this conclusion are best grouped into two categories: those that mandate a consolidation and those that will facilitate a consolidation. The factors mandating a consolidation include the problem of market volatility caused by intermarket trading,¹⁴⁸ the need to address intermarket issues¹⁴⁹ and the stifling of financial innovation.¹⁵⁰ The factors facilitating a consolidation are the similarities between securities and futures transactions¹⁵¹ and the similarities between the regulation of the two industries.¹⁵²

146. SEC, *Treasury, Greenspan Support Giving SEC Jurisdiction for Stock Index Futures*, 22 Sec. Reg. & L. Rep. (BNA) No. 13, at 459 (Mar. 30, 1990) (statement of Federal Reserve Board Chairman Alan Greenspan). For a discussion of the current regulatory scheme's stifling of financial innovation, see *infra* notes 235-47 and accompanying text.

147. Glickman, *Eckart Propose Replacing SEC, CFTC with Super Regulatory Agency*, 22 Sec. Reg. & L. Rep. (BNA) No. 14, at 495 (Apr. 6, 1990). The bill, H.R. 4477, would create a new agency called the Markets and Trading Commission that would have an entire division devoted solely to the futures industry to ensure that the securities industry would not be favored over the futures industry. *Id.*

148. For a discussion of market volatility, see *infra* notes 153-207 and accompanying text.

149. For a discussion of the issues connected with intermarket trading, see *infra* notes 208-34 and accompanying text.

150. For a discussion of how the present jurisdictional system has stifled financial innovation, see *infra* notes 235-47 and accompanying text.

151. For a discussion of the similarities between securities and futures transactions, see *infra* notes 248-75 and accompanying text.

152. For a discussion of the similarities between the regulation of the securities and futures industries, see *infra* notes 276-302 and accompanying text.

B. *Market Volatility*1. *Institutional Investors*

No analysis of market volatility is complete without a discussion of the role of institutional investors and program trading. During the 1980s, institutional investors came to dominate trading in the securities and the index-based futures markets.¹⁵³ Institutional investors, a class of investors that typically includes mutual funds, pension and endowment funds and other commercial enterprises, manage over \$2 trillion in assets on behalf of nearly one hundred million individual beneficiaries.¹⁵⁴ Institutions account for over eighty percent of trading in the securities markets¹⁵⁵ and as much as ninety-three percent of the trading in the Chicago Mercantile Exchange's S&P 500 index futures.¹⁵⁶ Because of their size and experience advantages over individuals, institutional investors can engage in trading strategies, such as program trading,¹⁵⁷ that individual investors find prohibitive and that impact the overall market profoundly.¹⁵⁸ In fact, the trading advantages enjoyed by institutional investors often make individual participants in the securities markets feel as if they are at the mercy of the institutions.¹⁵⁹ Nevertheless, institutional investors represent nearly one hundred million people, many of whom might not otherwise participate in the stock

153. Schick, *supra* note 6, at 48. For a detailed discussion of institutional investors and program trading, see *id.* at 48-53.

154. *Financial Market Hearings*, *supra* note 7, at 438 (testimony of Leo Melamed, Chairman, Chicago Mercantile Exchange). In fact, institutional investors represent over 33 million mutual fund shareholders and 60 million pension fund participants and beneficiaries. *Id.*

155. *Market Reform Hearings*, *supra* note 64, at 132. According to Senator Heinz, individuals accounted for only 18.5% of all volume in the securities markets in 1988. *Id.*

156. *Financial Market Hearings*, *supra* note 7, at 507. This figure is supported by the CME's large trader reporting figures, which indicate that between 80% and 90% of the S&P 500 index futures volume is traceable to large traders, those investors with over 100 contracts. *Market Reform Hearings*, *supra* note 64, at 106 (CME exhibit).

157. For a discussion of program trading, see *infra* notes 161-74 and accompanying text.

158. STAFF OF THE SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 100TH CONG., 1ST SESS., PROGRAM TRADING: PUBLIC POLICY ASPECTS OF INDEX ARBITRAGE 9-10 (Comm. Print 1987) [hereinafter PROGRAM TRADING REPORT]. This report estimates that \$5 million is the minimum commitment for engaging in index arbitrage, while the average commitment is somewhere between \$25 and \$50 million. *Id.* at 10. For a further discussion on the impact of program trading, see *infra* notes 159-93 and accompanying text.

159. *Market Reform Hearings*, *supra* note 64, at 268-69 (testimony of Charles Schwab, Chairman, Charles Schwab & Co.); see also *id.* at 277 (Investor Attitudes Questionnaire prepared by Opinion Research Corporation). According to the survey, 70% of individual investors believed that institutions dominated activity in the stock markets too much, while 81% believed that trading in index futures made understanding the stock market more difficult for individuals. *Id.*

market.¹⁶⁰

2. Program Trading

Program trading refers to contemporaneous purchases or sales of large blocks of stock and opposite positions in stock index futures which are intended to track changes in the value of major market indices.¹⁶¹ This trading strategy owes its name to the fact that the decision to trade is often made by a computer program and not by an individual money manager.¹⁶² Although program trading has become a generic term, it actually encompasses two distinct trading strategies, portfolio insurance and index arbitrage.¹⁶³

Institutional investors relied on portfolio insurance to protect the value of their investment portfolios prior to the 1987 stock market break.¹⁶⁴ Portfolio insurance refers to the practice of shifting investment away from equity securities in a declining stock market in order to maintain a portfolio's value.¹⁶⁵ Although some investors shifted to bonds and other debt instruments,¹⁶⁶ thereby maintaining corporate investment, most investors sought the protection afforded by the stock index futures markets.¹⁶⁷ As stock prices dropped, investors engaging in portfolio insurance would liquidate their stock investments, thereby further depressing stock prices, and acquire positions in index futures; once stocks became sufficiently discounted, investors would reinvest in the stock market.¹⁶⁸ The 1987 stock market break showed, however,

160. *Financial Market Hearings*, *supra* note 7, at 438.

161. *Market Reform Hearings*, *supra* note 64, at 268-69 (testimony of Charles Schwab).

162. R. HAMILTON, *supra* note 57, at 491-92.

163. Schick, *supra* note 6, at 50-52. For a discussion of portfolio insurance, see *infra* notes 164-69 and accompanying text. For a discussion of index arbitrage, see *infra* notes 170-74 and accompanying text.

164. Pickard & Axe, *The History and Mechanics of Index Futures and Program Trading*, in *TRADING PRACTICES, THE PORTFOLIO EXECUTION PROCESS, AND SOFT DOLLAR PRACTICES 1990*, at 83, 93-94 (1990) (Practising Law Institute, Corporate Law and Practice Course Handbook No. 684).

165. *Id.* Because of its asset protection feature, portfolio insurance has been compared to traditional "stop-loss" orders, which are placed with one's broker to sell a particular security once its price drops to a certain level. SEC CRASH REPORT, *supra* note 67, at 1-2.

166. Pickard & Axe, *supra* note 164, at 93.

167. *Id.* As stock prices fell, investors engaging in portfolio insurance sold index futures. *Id.* Thus, investors engaging in portfolio insurance used index futures to hedge against declines in the value of their underlying commodity holdings, their securities portfolios, in much the same way as grain producers sell grain futures to protect against declines in grain prices. *Id.* By selling index futures in the face of declining stock prices, investors engaging in portfolio insurance were theoretically perfectly hedging their securities portfolios. SEC CRASH REPORT, *supra* note 67, at 1-2. For further discussion of the hedging role of futures, see *supra* notes 24-25 and accompanying text.

168. SEC CRASH REPORT, *supra* note 67, at 1-2. Although early portfolio insurance practices involved the purchase of baskets of stocks to offset potential

that portfolio insurance could not adequately protect portfolio value and therefore, the strategy is rarely employed today.¹⁶⁹

The second and far more controversial form of program trading is index arbitrage. Index arbitrage refers to the practice of contemporaneously buying and selling opposing positions in the stock and stock index futures markets in order to capitalize on minute valuation differences in a stock index future and its underlying stock index.¹⁷⁰ Index arbitrage is basically a riskless form of trading. As long as the performance of the securities bought or sold in the trade matches the performance of the underlying index, the arbitrageur's profit, the difference in the value of the index and the index future, minus transaction costs, is fixed at the time of the trade.¹⁷¹

Index arbitrage impacts the securities markets in two ways. First, many investors believe that trading in the futures market signals positive or negative sentiment which then translates into higher or lower stock prices.¹⁷² Second, the expiration of futures contracts can result in severe short-term price volatility as arbitrageurs conduct massive trades in the securities markets in order to close out their positions.¹⁷³ Because arbitrage can have a profound impact on securities prices otherwise unrelated to economic factors, and arbitrageurs are mainly large institutional investors, individual investors and many large brokerage houses tend to assail index arbitrage and blame much of the stock market's woes on the strategy.¹⁷⁴

3. *Evidence of Excessive Market Volatility Caused by Intermarket Trading*

By all accounts, the securities and securities-based futures markets have become a linked marketplace, used almost interchangeably by insti-

losses in the existing portfolio, investors soon switched to index futures because trading in one single product, index futures, involved lower transaction costs and time expenditures. *Id.*

169. Pickard & Axe, *supra* note 164, at 93-94.

170. PROGRAM TRADING REPORT, *supra* note 158, at 1-2.

171. *Id.* at 2. In order to engage in index arbitrage, an arbitrageur has to purchase a variety of stocks in an attempt to recreate the underlying security. *See id.* As long as the stocks purchased match the performance of the underlying index, the arbitrageur can realize a profit from the transaction. *See id.* at 3. If, however, the stocks fail to match the underlying index, the arbitrageur runs the risk of not realizing a profit. *See id.*

172. Pickard & Axe, *supra* note 164, at 96. Pickard and Axe noted that "the underlying market value of index futures traded daily generally exceeds the dollar volume on the NYSE. Accordingly, market movements are now frequently observed first in the futures markets." *Id.* at 97.

173. PROGRAM TRADING REPORT, *supra* note 158, at 22.

174. *See Market Reform Hearings*, *supra* note 64, at 268-69, 277 (testimony of Charles Schwab and results of investor survey conducted by Opinion Research Corporation). In his testimony concerning index arbitrage, Charles Schwab stated that the average American investor "loses confidence when blue-chip stocks are whipsawed by rapid, computer-driven trading that has nothing to do with the stocks' fundamental value." *Id.* at 269.

tutional investors.¹⁷⁵ Events in the futures market can have a profound impact on the related securities market.¹⁷⁶ The impact can be so great that many investors now believe that market swings are initiated in the futures markets.¹⁷⁷ Price fluctuations that reflect changing investor attitudes are not inherently damaging to the securities markets. However, when severe fluctuations over short periods of time are caused by factors other than economic considerations, the integrity of the securities markets may be imperiled.¹⁷⁸ Although excessive market volatility is not caused by the present jurisdictional structure, its failure to effectively address the problems caused by intermarket trading has exacerbated the problems.¹⁷⁹ Thus, it is submitted that a consolidation of the CFTC and the SEC is necessary to effectively address the problem of excessive market volatility caused by trading in related, interchangeable markets. The

175. BRADY REPORT, *supra* note 8, at vi ("From an economic viewpoint, what have been traditionally seen as separate markets—the markets for stocks, stock index futures, and stock options—are in fact one market. Under ordinary circumstances, these marketplaces move sympathetically, linked by financial instruments, trading strategies, market participants and clearing and credit mechanisms."); GAO CRASH REPORT, *supra* note 132, at 95 ("[T]he October trading exemplifies the significance and ramifications of the new futures, options and equity market linkages and trading strategies, as well as the development of new broad market interests of institutions.").

176. GAO CRASH REPORT, *supra* note 132, at 95 (linked futures and securities markets can "contribute to creating an atmosphere that could disrupt confidence and greatly complicate decisionmaking by investors, portfolio managers, SRO officials and federal regulators").

177. Pickard & Axe, *supra* note 164, at 96. This argument is supported by the general role of futures in discovering the proper price of the underlying commodity. Board of Trade v. S.E.C., 677 F.2d 1137, 1151 (7th Cir.) (futures trading "serves legitimate hedging and price discovery functions, thereby facilitating production of the underlying commodity"), *vacated as moot*, 459 U.S. 1026 (1982).

178. *Financial Market Hearings*, *supra* note 7, at 219 (testimony of David Ruder, Chairman, SEC). Chairman Ruder stated that

[w]hile limited price volatility that reflects fundamental changes in buying and selling interest is not inherently bad or damaging to the markets, extreme price movements in short periods of time can have a number of damaging effects. First, extreme price volatility can increase substantially the risk encountered by market makers and may have long term effects on market liquidity. Second, more volatile markets can decrease the ability of broker-dealers to use their capital effectively. To the extent risk of loss increases substantially, firms may be required to maintain greater capital reserves to satisfy both creditors and regulators. Finally, such volatility may make it more difficult for corporations to raise equity capital by decreasing the willingness of the public to invest directly in the stock market.

Id. at 219-20.

179. BRADY REPORT, *supra* note 8, at vi; *see also Financial Market Hearings*, *supra* note 7, at 258 (testimony of David Ruder, Chairman, SEC). Chairman Ruder testified that "[n]either as a matter of regulatory efficiency nor as a matter of public confidence does it make sense to maintain separate authority over the stock index futures and the stock markets." *Financial Market Hearings*, *supra* note 7, at 258.

remainder of this section will focus on the cascade theory,¹⁸⁰ the triple witching hour phenomenon¹⁸¹ and trading activity surrounding the October 1987 market break¹⁸² to demonstrate how intermarket trading can in fact cause market volatility.

The cascade theory indicates precisely how intermarket trading can lead to and further exacerbate volatile price swings. The theory begins with the assumption that large institutional investors are using index futures to hedge positions in the securities markets.¹⁸³ When portfolio managers learn of bad economic news, they will hedge their equity positions by selling index futures. This selling spree will cause index futures to become discounted in relation to their underlying indices.¹⁸⁴ Discounted futures will induce index arbitrageurs to buy futures and sell stock contemporaneously.¹⁸⁵ The selling activity by arbitrageurs will further deflate stock prices, thereby initiating a new round of index futures selling by hedging portfolio managers. Thus, the use of index futures to hedge equity positions, i.e. portfolio insurance, could, in the face of adverse economic news, lead to crashing stock prices which would end only when stocks were sufficiently undervalued so as to induce buying.¹⁸⁶ Although the possibility of a cascade actually occurring

180. For a discussion of the cascade theory, see *infra* notes 183-87 and accompanying text.

181. For a discussion of the triple witching hour phenomenon, see *infra* notes 188-95 and accompanying text.

182. For a discussion of the trading activity surrounding the stock market break of October 1987, see *infra* notes 196-207 and accompanying text.

183. GAO CRASH REPORT, *supra* note 132, at 31. For a discussion of hedging, see *supra* notes 24-25 and accompanying text. For a discussion of portfolio insurance, see *supra* notes 164-69 and accompanying text.

184. Pickard & Axe, *supra* note 164, at 97. Under normal circumstances, the value of the index future should closely track the value of its underlying index. *Id.* When large sales of index futures in the futures markets are not accompanied by large purchases in the stock markets, however, as would be the case in a cascade scenario, the price of the index future will fall below the corresponding value of the underlying securities index. GAO CRASH REPORT, *supra* note 132, at 31. This imbalance will in turn induce trading by index arbitrageurs. *Id.*

185. PROGRAM TRADING REPORT, *supra* note 158, at 2-3. The imbalance between the price of the index futures and the value of the underlying index will ensure the arbitrageur a profit on the transaction. *Id.* For a discussion of the mechanics of an index arbitrage transaction, see *supra* notes 170-71 and accompanying text.

186. GAO CRASH REPORT, *supra* note 132, at 31. The cascade theory has encountered a considerable amount of criticism, particularly from the CFTC and the futures industry. COMMODITY FUTURES TRADING COMMISSION STAFF, STOCK INDEX FUTURES AND CASH MARKET ACTIVITY—OCTOBER 1987. 32-33 [hereinafter CFTC CRASH REPORT], reprinted in [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,117 (Jan. 29, 1988). The CFTC argues that the cascade theory ignores the stabilizing effect of index future purchases by speculators (arbitrageurs) and that the second cycle of hedging is unlikely because short hedging becomes more expensive when futures are underpriced relative to stock prices. *Id.* In addition, other commentators have suggested that the SEC's short sale

has decreased along with the use of portfolio insurance, the theory clearly illustrates how unfettered trading in the index futures market can lead to volatile price changes in the underlying securities market.¹⁸⁷

A variant of the cascade theory is the triple witching hour phenomenon. The triple witching hour refers to the last hour of trading on the date that stock options, stock index options and stock index futures all expire.¹⁸⁸ When index futures expire, the value of the future will equal the value of the underlying index.¹⁸⁹ Index arbitrageurs traditionally wait until the last hour of trading to liquidate their arbitrage positions, either by buying or selling stock, thereby causing severe order imbalances and short term price volatility.¹⁹⁰ In an attempt to curb such violent market activity, the New York Stock Exchange and the Chicago Mercantile Exchange, the markets most affected by triple witching hour activity, entered into an agreement whereby the expiration of the S&P's 500 futures contract was moved to the open of trading on Fridays, instead of the close of trading.¹⁹¹ Although this agreement has reduced the bulk of triple witching hour activity, market volatility surrounding "expiration Fridays" is still possible for two reasons.¹⁹² First, moving the expiration of the S&P 500 contract to Friday's opening merely makes

regulations will prevent much of the selling activity and that bottomed-out stock prices will induce large-scale stock buying. GAO CRASH REPORT, *supra* note 132, at 31. The SEC, however, maintains that a cascade could still occur despite the aforementioned factors. SEC CRASH REPORT, *supra* note 67, at 1-10.

187. See *Market Reform Hearings*, *supra* note 64, at 32 (testimony of John Phelan, Chairman and CEO, NYSE). Among the reforms that should reduce the likelihood of a cascade are an agreement between the New York Stock Exchange and the Chicago Mercantile Exchange to suspend trading in the S&P 500 futures contract for one hour if the value of the contract falls 12 points (equivalent to a 96 point drop in the Dow Jones Industrial Average) and a coordinated circuit-breaker under which all U.S. securities and futures markets will suspend trading in the event of a 250 point decline in the Dow from the last day's close. *Id.* at 32, 40. For a discussion of portfolio insurance, see *supra* notes 164-69 and accompanying text.

188. Schick, *supra* note 6, at 53.

189. *Id.* The value of index futures always equals the value of the underlying index at the time of expiration, because the price of the futures contract is recalculated daily to reflect that day's changes in the underlying index. Pickard & Axe, *supra* note 164, at 95. Thus, as the index future expires, its price is being recalculated to equal the value of the underlying index. See *id.*

190. Schick, *supra* note 6, at 53. The last hour of trading is critical to an index arbitrage transaction. *Id.* In order to close out the transaction, the arbitrageur must both settle obligations created by the futures contract, normally by offset or cash settlement, and liquidate the portfolio of stock that theoretically is tracking the performance of the underlying index. PROGRAM TRADING REPORT, *supra* note 158, at 2-3. Because the value of the index future will equal the value of the underlying index at the time of expiration, the arbitrageurs wait to liquidate until the value of the index has all but been determined, which is normally shortly before the end of trading on expiration day. Schick, *supra* note 6, at 53.

191. *Market Reform Hearing*, *supra* note 64, at 41 (testimony of John Phelan, Chairman and CEO, NYSE).

192. Schick, *supra* note 6, at 53.

the final hour of trading on Thursday more susceptible to volatility.¹⁹³ Second, the agreement does not include the Chicago Board Options Exchange and the American Stock Exchange, the largest index options markets,¹⁹⁴ or the Chicago Board of Trade, Kansas City Board of Trade or the New York Mercantile Exchange, the other exchanges trading index futures, thereby keeping open the possibility of some volatility caused by expiration Friday.¹⁹⁵

The final evidence of excessive market volatility caused by intermarket trading is the trading activity surrounding the October 1987 stock market break. Although all studies on the market break agree that intermarket trading did not cause the market break, most assert that such trading activity exacerbated the decline.¹⁹⁶ Although index arbitrage played a limited role on October 19, 1987, the recognized date of the "crash," it played a significant role in the tumultuous days preceding the market decline.¹⁹⁷ Index arbitrageurs accounted for between ten and fifteen percent of the sell volume on the New York Stock Exchange during the week before the break.¹⁹⁸ Since Friday, October 16, 1987, was the expiration date of most index options and the CBOT's Major Market Index future, arbitrage activity was concentrated in the last hour

193. *Id.* The last hour of trading on Thursdays will become vulnerable to volatile price swings as index arbitrageurs sell large blocks of stock in order to match the value of the underlying index as it will open on Friday. *Id.*; see also, Pickard & Axe, *supra* note 164, at 95. Because only the arbitrageurs using index futures will be selling off on Thursday afternoons, this price volatility should not be as severe as on earlier expiration Fridays where traders with positions in index options and stock options would sell large blocks of stock in order to wind-up their positions. See *id.*; see also *Market Reform Hearings*, *supra* note 64, at 42 (testimony of John Phelan, Chairman and CEO, NYSE).

194. *Market Reform Hearings*, *supra* note 64, at 42 (testimony of John Phelan, Chairman and CEO, NYSE).

195. *Id.* at 41-43. The only parties to the agreement are the New York Stock Exchange and the Chicago Mercantile Exchange and the only index future covered by the agreement is the CME's S&P 500 future. *Id.* Thus, all index options and all of the other index futures still expire on Fridays. *Id.* at 42. Although the S&P 500 contract accounts for two thirds of all index futures trading, the expiration of index options and futures on Fridays still creates imbalances and some volatile price swings. *Id.*

196. See BRADY REPORT, *supra* note 8, at 69; SEC CRASH REPORT, *supra* note 67, at xiii ("[F]utures trading and strategies involving the use of futures were not the 'sole cause' of the market break. Nevertheless, [these strategies] were a significant factor in accelerating and exacerbating the declines."); GAO CRASH REPORT, *supra* note 132, at 49 ("It does seem clear, however, that the relationship between futures prices and cash market prices . . . had some effect on investors' perceptions of events."). But see CFTC CRASH REPORT, *supra* note 186, at 137 ("A detailed examination of the trading data . . . does not provide empirical support for the theory that hedging in the futures market and index arbitrage activities interacted to cause a technical downward price spiral of stock prices.").

197. CFTC CRASH REPORT, *supra* note 186, at 38.

198. *Id.* On Wednesday, October 14, 1987, index arbitrageurs accounted for 13.4% of the total sell volume on the New York Stock Exchange, 6.2% on Thursday, October 15, and 11% on Friday, October 16. *Id.*

of trading.¹⁹⁹ This heavy arbitrage activity undoubtedly added significantly to the sell pressure which built over the weekend,²⁰⁰ the large discount in the CME's S&P 500 future on Monday morning²⁰¹ and the massive dumping of stock by institutional investors during the first hour of trading on Monday.²⁰² Although index arbitrage and other forms of intermarket trading clearly did not cause the unprecedented decline on October 19, 1987, the mere fact that it played a minor, exacerbating role is cause for great concern.²⁰³

4. *The Need for Regulatory Consolidation to Address Market Volatility*

The preceding sections have shown how trading in the index futures market can cause serious volatility in the underlying securities markets.²⁰⁴ While the CFTC regulates the index futures and the SEC

199. See *id.* at vii; SEC CRASH REPORT, *supra* note 67, at 2-36. Index arbitrage selling was particularly heavy between 3:10 p.m. and 3:40 p.m., at times accounting for over 60% of all NYSE volume. *Id.* Index arbitrageurs sold nearly twelve million shares on the NYSE during Friday's final hour of trading. *Id.* at 2-35. For a discussion of the effect that options and futures expiration have on stock prices, see *supra* notes 188-95 and accompanying text.

200. GAO CRASH REPORT, *supra* note 130, at 42.

201. *Id.* When the NYSE opened on Monday, the S&P 500 futures contract was discounted 21 points from the value of the S&P index. *Id.*

202. *Id.*

203. The role of intermarket trading in the market break is cause for concern because the market came very close to suffering a true cascade. The S&P 500 futures contract was discounted 21 points when the NYSE opened on Monday, October 19, 1987. *Id.* In the first hour of trading on Monday, program trading sales accounted for between 5% and 60% of all NYSE volume, with index arbitrage activity responsible for over 75% of this amount. SEC CRASH REPORT, *supra* note 67, at 2-38 to 2-39. During the first hour of trading, the Dow Jones Industrial Average fell almost 200 points. *Id.* at 2-13. Falling stock prices in turn caused traders engaging in portfolio insurance to begin selling index futures. In fact, portfolio insurance sales of S&P 500 futures contracts accounted for 30% of all CME futures volume between 10:30 a.m. and 11:00 a.m. and approximately 45% of all CME volume between 12:00 p.m. and 12:30 p.m. *Id.* at 2-40. This futures selling activity caused the S&P 500 futures contract to become discounted eight points from the S&P 500 index by 12:30 p.m. (after having briefly regained its proper position somewhat close to the value of the index). BRADY REPORT, *supra* note 8, at III-19. At approximately 1:10 p.m., program selling increased to a point where it accounted for over 60% of the NYSE volume for three ten-minute intervals before 2:00 p.m. SEC CRASH REPORT, *supra* note 67, at 2-39. This intense selling spree caused the Dow to drop 100 points between 1:00 p.m. and 2:00 p.m. BRADY REPORT, *supra* note 8, at III-17. As a result of this precipitous decline in stock prices, portfolio insurers stepped up their sales of index futures. SEC CRASH REPORT, *supra* note 67, at 2-40. Although the foregoing events do not necessarily mean that a cascade actually occurred, the fact that otherwise independent events occurred in the order envisioned in the cascade theory supports the argument that intermarket trading could potentially lead to a market disaster. For a discussion of the mechanics of the cascade theory, see *supra* notes 183-87 and accompanying text.

204. For a discussion of market volatility, see *supra* notes 175-203 and accompanying text.

regulates the underlying securities markets, neither agency has the authority to address directly the market volatility caused by intermarket trading.²⁰⁵ Any progress in this direction requires either cooperation between the exchanges or between the agencies. Although inter-exchange cooperation has been somewhat successful,²⁰⁶ inter-agency cooperation has been limited and is very unlikely to occur in the near future.²⁰⁷ Thus, Congress must take the steps necessary to ensure proper regulation of intermarket trading, and consolidation of the agencies is the most logical means of achieving this goal.

C. *Intermarket Issues*

1. *Introduction*

The 1987 market break clearly indicated that technical reforms were needed to alleviate the problems associated with intermarket trading. Among the reforms most urgently needed were coordinated clearing and settlement mechanisms,²⁰⁸ consistent margin requirements for securities and securities-based futures²⁰⁹ and implemented circuit breakers and emergency powers.²¹⁰ Although some of these reforms have been partially achieved through inter-exchange agreements, inter-agency cooperation will be needed to achieve all such measures.²¹¹ Because this degree of cooperation is highly unlikely in light of the recent conflicts between the agencies,²¹² Congress should intervene and force cooperation through a consolidation of the agencies.

205. See BRADY REPORT, *supra* note 8, at 59.

206. See, e.g., *Market Reform Hearings*, *supra* note 64, at 32-33 (testimony of John Phelan, Chairman and CEO, NYSE). Examples of inter-exchange cooperation include a NYSE-CME agreement to take certain actions when the value of the S&P futures contract declines 12 points, an inter-exchange hotline for the sharing of information, agreements on intermarket frontrunning and a NYSE-CME agreement on the timing of the expiration of the S&P 500 futures contract. *Id.*

207. See *Financial Market Hearings*, *supra* note 7, at 499 (statement of Representative Rinaldo) ("One of the . . . reasons for the formation of the working group was that . . . there was a lack of coordination between the markets and the regulators.").

208. BRADY REPORT, *supra* note 8, at vii. For a discussion of clearing and settlement mechanisms, see *infra* notes 213-17 and accompanying text.

209. *Id.* For a discussion of margin requirements, see *infra* notes 218-27 and accompanying text.

210. *Id.* For a discussion of circuit breakers and emergency powers, see *infra* notes 228-34 and accompanying text.

211. See *Market Reform Hearings*, *supra* note 64, at 40 (testimony of John Phelan, Chairman and CEO, NYSE) (circuit breaker agreement between NYSE and CME); *Financial Market Hearings*, *supra* note 7, at 470 (testimony of John Phelan, Chairman and CEO, NYSE) (NYSE and CME working to confront intermarket frontrunning problem).

212. For a discussion of the recent disputes between the SEC and the CFTC, see *supra* notes 104-27 and accompanying text.

2. *Coordinated Clearing and Settlement*

At present, the clearing and settlement of a futures or securities transaction occurs in the exchange's clearinghouse.²¹³ This system poses two problems when faced with contemporaneous trading on securities and futures exchanges. First, an index arbitrage trade, in which an investor focuses on the price discrepancy between a stock index and its related futures contract, requires two separate clearing and settlement transactions.²¹⁴ Even though the investor is essentially "buying into" one market, he must do so in two separate marketplaces which may employ vastly different procedures. Second, the disjointed system of clearing prevents a clearinghouse from accurately gauging the intermarket exposure of its customers.²¹⁵ These problems become particularly acute when an investor trades on margin in both the securities and futures markets.²¹⁶ Although the agencies, exchanges and commentators agree that the clearing and settlement of securities and related futures must be coordinated, there has been little progress in this direction.²¹⁷

3. *Consistent Margin Requirements*

Margins, the extension of credit in a securities or futures transaction, have attracted a great deal of attention since the 1987 market break.²¹⁸ The SEC and securities industry have argued that lower margin requirements for index futures enable speculators to acquire large futures positions on credit, thereby increasing the potential for volatility in the securities markets.²¹⁹ Presently, margins on securities, estab-

213. GAO STAFF STUDY, *supra* note 17, at 66. The major responsibility of the clearinghouse is to ensure that sales of securities or futures match with purchases. 1 P. JOHNSON & T. HAZEN, *supra* note 18, at § 1.31.

214. BRADY REPORT, *supra* note 8, at 64 ("The complexity and fragmentation of the separate clearing mechanisms in stocks, futures and options . . . brought the financial system to the brink on Tuesday, October 20.").

215. *Id.* ("No clearinghouse is able to assess accurately intermarket exposure among its clearing members and among their customers. Separate clearing also hampers lenders in assessing the risk exposure of market participants . . .").

216. *Id.*

217. *Id.* at vi; see also *Market Reform Hearings*, *supra* note 64, at 234 (letter to Senator Dodd from Nicholas Brady, Secretary of the Treasury) ("[T]he proper functioning of clearance and settlement systems is integral to the proper functioning of the financial markets as a whole."). A bill, known as the Coordinated Clearance and Settlement Act of 1990, requiring the SEC to establish a linked or coordinated clearing system was introduced in Congress in 1990. H.R. 3656, 101st Cong., 2d Sess. (1990).

218. See BRADY REPORT, *supra* note 8, at vii.

219. *Financial Market Hearings*, *supra* note 7, at 246 (testimony of David Ruder, Chairman, SEC). Chairman Ruder testified that "[f]utures products enjoy greater leverage in part because they are cash-settled and have lower margins. This greater leverage permits major long futures positions to be established with relatively small initial capital." *Id.* (footnote omitted).

lished by the Federal Reserve Board, are set at fifty percent of the total purchase price.²²⁰ Thus, an investor can buy \$100,000 worth of stock by paying \$50,000 down and receiving \$50,000 of credit. Futures margins, presently established by the individual futures exchanges, are generally set far below the margins on securities.²²¹ For example, the margin requirement for the S&P 500 futures has typically hovered around fifteen percent of the value of the contract.²²² Thus, for an initial investment of \$15,000, an investor could acquire S&P 500 futures with a value of \$100,000.

The futures exchanges justify this margin discrepancy by arguing that futures margins play a fundamentally different role than securities margins.²²³ Although a futures margin is a grant of credit, it is also collateral which serves to ensure a party's performance under the contract.²²⁴ The exchanges also argue that the daily marking-to-market feature of futures contracts, pursuant to which a trader must pay additional money if the value of the contract falls below a certain maintenance level, entitles the exchanges to set futures margins at a level below securities margins.²²⁵ Securities officials concede that futures margins need not be set at fifty percent, but argue that they should be set at a level above fifteen percent in order to remove leveraging advantages.²²⁶

Despite the attractiveness of the futures exchanges' arguments,

220. *Id.* Margins for institutional investors in the securities markets, however, are established by their creditors and can run as low as 20% to 30% of the value of the securities being acquired. *Id.* at 334 (testimony of Wendy Gramm, Chairperson of CFTC).

221. GAO STAFF STUDY, *supra* note 17, at 71. A 1990 compromise measure tied to the CFTC reauthorization bill attempted to shift regulation of futures margins to the Federal Reserve Board, but the measure never made it to the floor of Congress. *Senators Fail in Last-Minute Effort to Resolve SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA) No. 41, 1476-77 (Oct. 19, 1990). CFTC Commissioner William Albrecht argued that if futures margins were increased, "individual investors—like Goldilocks of *Goldilocks and the Three Bears*—will say: 'These margins are too high, these returns are too soft, these regulations are too hard.' These investors will leave the U.S. markets and 'find a market that is just right.'" *Id.* at 1476.

222. *Financial Market Hearings*, *supra* note 7, at 407 (testimony of Leo Melamed, Chairman of CME).

223. HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS: SUBCOMM. ON DOMESTIC MONETARY POLICY, 100TH CONG., 2D SESS., REPORT ON THE REGULATION OF FUTURES MARGINS I (Comm. Print 1988) [hereinafter FUTURES MARGINS REPORT]; see also *Review of Recent Volatility in the Stock Market and the Stock Index Futures Market, Hearing Before the Subcomm. on Conservation, Credit and Rural Development of the House Comm. on Agriculture*, 100th Cong., 1st Sess. 29 (1987) (testimony of Kalo Hineman, Acting Chairman, CFTC) (increasing futures margins to 50% would be analogous to "saying that the insurance on a house should be the same amount of money as the down payment on a house").

224. FUTURES MARGINS REPORT, *supra* note 223, at 2. The report analogized futures margins to performance bonds. *Id.*

225. *Id.* Thus, a futures margin must be set at a level sufficient to protect against only a single day's price movements. *Id.*

226. *Financial Market Hearings*, *supra* note 7, at 240-49 (testimony of David

margins on index futures should be set at a level theoretically comparable to securities margins. Futures margins, although an assurance of performance, are nonetheless credit transactions in which an investor can acquire a very valuable asset for a small down-payment. If the value of the contract never falls below the maintenance requirement, the investor will never be required to pay additional money. Therefore, with a small initial investment, a trader can acquire a significant position in the index futures market with which to engage in arbitrage or other intermarket trading techniques.²²⁷

4. *Unified Circuit Breakers and Emergency Powers*

The volatile trading session of October 19, 1987, indicated that actions taken on one exchange or by one regulator can have a profound impact on other related markets. On that day, rumors of the impending closing of the New York Stock Exchange sent shock waves through the securities and futures markets and resulted in the halting of trading in S&P 500 futures on the Chicago Mercantile Exchange.²²⁸ Because of this closing, many traders were unable to liquidate open futures positions or utilize index futures to hedge positions in the falling securities market.²²⁹ Furthermore, activity on October 13, 1989, also reflected the impact of trading events in one market on a related market. On that day, trading in the S&P 500 future was halted for an hour, pursuant to a newly implemented circuit breaker,²³⁰ because the value of the future had dropped twelve points.²³¹ The trading halt temporarily abated the general stock market decline as well as the rate of index arbitrage selling activity.²³² Once the trading halt was lifted, however, the price decline

Ruder, Chairman, SEC). The SEC suggested that a margin level of 20% to 25% for futures would reduce the leverage advantage. *Id.* at 248-49.

227. For a discussion of index arbitrage and its effect on the securities markets, see *supra* notes 170-79 and accompanying text.

228. GAO CRASH REPORT, *supra* note 132, at 92. The CME halted trading in index futures because officials feared that the closing of other markets would cause anxious investors to swamp the CME, thereby severely devaluing the S&P 500 futures contract. *Id.* In addition to the CME, the CBOE, Kansas City Board of Trade, New York Futures Exchange, American Stock Exchange and Philadelphia Stock Exchange all halted index-related trading. *Id.* at 92 & n.2. Chicago Board of Trade, however, never halted index trading. *Id.*

229. *Id.* at 93.

230. A circuit breaker is an automatic trading halt that is triggered when trading activity reaches a certain level. BRADY REPORT, *supra* note 8, at 66.

231. *Shock Absorbers Did Not Curb Volatility in Oct. 1989 Market Swings*, Report Says, 22 Sec. Reg. & L. Rep. (BNA) No. 20, at 774 (May 18, 1990) (report by CFTC's Divisions of Economic Analysis and Trading and Markets on the October 1989 stock market decline). For a discussion of the circuit breaker involved in this market decline, see *supra* note 187.

232. DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMM'N, TRADING ANALYSIS OF OCTOBER 13 AND 16, 1989, reprinted in [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,603 (May 1990) (report of SEC's Division of Market Regulation on October 1989 stock market decline).

resumed.²³³ Although general circuit breakers are already in place to slow precipitous declines in the securities and futures markets, no agency has the authority to exercise other forms of emergency powers, such as delaying openings or closing entire markets, over the entire securities and securities-based futures markets.²³⁴ Such emergency powers would be most effective if both markets were already subject to regulation by the agency exercising the emergency powers; thus, the need for emergency powers supports a consolidation of the agencies.

D. *Stifling of Financial Innovation*

1. *Index Participations*

The clearest example of the carnage wrought by the jurisdictional conflict is the death of the index participation.²³⁵ In *Chicago Mercantile*, the Seventh Circuit held that index participations, although not specifically futures, fell within the CFTC's jurisdiction under the exclusivity clause and, therefore, could not be traded on securities exchanges.²³⁶ The Seventh Circuit noted that "the IP was designed as a novel instrument so that it could offer attributes previously missing in the market."²³⁷ Nevertheless, in one fell swoop, a beneficial financial instrument²³⁸ which had been developed over several years²³⁹ and which had been recommended as a means of preventing future stock market crashes²⁴⁰ was removed from the financial scene. The *Chicago*

233. *Id.*

234. *Market Reform Hearings*, *supra* note 64, at 40 (testimony of John Phelan, Chairman and CEO, NYSE). The exchanges have entered into an agreement that all U.S. securities and futures markets will close for one hour should the Dow Jones Industrial Average drop 250 points from the close of the previous day's trading. *Id.* Although this is a start, the triggering event is most likely set at an unrealistically high level. *Id.* at 271 (testimony of Charles Schwab, Chairman, Charles Schwab & Co.). A 250 point drop in the Dow is equivalent to the percentage decline in the October 1929 stock market crash. *Id.* Thus, until the Dow drops an amount equalling the 1929 stock market crash, the only operative circuit breaker will be the CME's trading halt when the S&P 500 futures contract drops 12 points. The volatility of October 13, 1989, when trading in the S&P contract was halted for an hour, indicated that circuit breakers which affect only one market do more harm than good. *Shock Absorbers Did Not Curb Volatility in Oct. 1989 Market Swings, Report Says*, 22 Sec. Reg. & L. Rep. (BNA) No. 20, at 774 (May 18, 1990) (report of CFTC's Divisions of Economic Analysis and Trading and Markets on October 1989 stock market decline).

235. For a discussion of index participations and the *Chicago Mercantile* decision, see *supra* notes 104-24 and accompanying text.

236. *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 550 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 3214 (1990).

237. *Id.* at 546. For a discussion of the unusual attributes of the various index participations, see *supra* notes 104-14 and accompanying text.

238. *Market Reform Hearings*, *supra* note 64, at 132 (statement of Senator John Heinz). For the full text of this statement, see *supra* note 115.

239. See POWER OF SIMPLICITY, *supra* note 104, at 4. The Philadelphia Stock Exchange began development of its CIP in 1985. *Id.*

240. SEC CRASH REPORT, *supra* note 67, at 3-18. The SEC suggested that

Mercantile decision, and the jurisdictional disputes in general, have resulted in "a substantial risk in creating, marketing, or investing in many new products" which are not clearly either securities or futures.²⁴¹

2. *Off-Exchange Hybrid Instruments*

Off-exchange hybrids are financial products with characteristics of both securities and futures that are sold over-the-counter.²⁴² For example, an oil company may issue debt instruments with interest rates tied to oil prices or an international corporation may issue securities accompanied by warrants to purchase foreign currencies.²⁴³ The principal advantages of such hybrid instruments is that they provide a relatively inexpensive means of raising capital as well as allowing companies to hedge against rising commodities prices.²⁴⁴ Because hybrid products have elements of a futures contract, they are subject to the provisions of the Commodities Exchange Act and more importantly, the rule requiring all futures contracts to be sold on registered futures exchanges.²⁴⁵ Although the CFTC is in the process of formulating exemptions for such hybrid products,²⁴⁶ the uncertainty surrounding this prospect has slowed product development and even driven some products, such as swaps, to overseas markets.²⁴⁷

the exchanges, particularly the NYSE, study the feasibility of market basket trading of stocks on the stock exchange as an alternative to index arbitrage transactions involving both the securities and futures markets. *Id.* This proposal would cut down on transaction costs and ameliorate the volatile impact of index arbitrage, while still allowing investors to play the market as a whole. *Id.*

241. Schneider & Schapiro, *supra* note 2, at 83. The risks involved with new hybrid instruments include a loss of the time and money expended by the exchanges in creating the products, the difficulty that brokerage houses face in marketing products with "legal clouds" and the possibility that investors could lose the value of their investments. *Id.*

242. Gerstell, *Developments in Off-Exchange Financial Products*, 21 REV. SEC. & COMMODITIES REG. 1, 1-2 (1988).

243. *Id.*

244. *Id.* For example, an oil company could tie interest rates on its bonds to the price of oil. *Id.* This way, the cost of borrowed money would decline as the value of the company's product declined, thereby protecting the company's balance sheet. *Id.*

245. See 7 U.S.C. § 2 (1988) (definition of "contract of sale" under CEA).

246. Russo & Mitchell, *Commodity Price Exposure Management*, in NEW DEVELOPMENTS IN COMMODITY FUTURES REGULATION AND ENFORCEMENT 1989, at 475, 489 (1989) (Practising Law Institute, Corporate Law and Practice Course Handbook No. 667). A bill introduced in Congress in 1990 would give the CFTC express authority to exempt currency and interest rate swap agreements from CFTC regulation; the bill, however, never made it to floor consideration. *Senators Fail in Last-Minute Effort to Resolve SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA), No. 41, at 1477 (Oct. 19, 1990).

247. Schneider & Schapiro, *supra* note 2, at 86. The exemption process is being slowed by the futures exchanges which "fear[] that the new financial products will siphon away dollars and participants." Gerstell, *supra* note 242, at 2.

E. *Similarity of Transactions*1. *In General*

The previously stated factors mandate a consolidation of the SEC and the CFTC.²⁴⁸ The following sections will discuss several factors which will facilitate a consolidation of the agencies. One of the CFTC's major arguments for retaining the present jurisdictional system is that the CFTC regulates futures, and futures transactions are fundamentally different than securities transactions.²⁴⁹ This section will demonstrate, however, that, despite some differences, futures and securities transactions occur in a similar fashion and for similar purposes.

2. *Form of Transactions*

Opponents of a jurisdictional realignment argue strenuously that futures transactions are fundamentally different than securities transactions.²⁵⁰ Futures trading basically entails the formation of a contract for the future delivery of a commodity.²⁵¹ Any profit realized from the transaction is generally traceable to movements in the price of the underlying commodity during the life of the contract.²⁵² Despite the close ties to the underlying commodity, most futures contracts are extinguished prior to delivery through offset or cash settlement.²⁵³ Thus, a futures contract is no more than a cash transaction which results in the passage of title to rights in an asset, specifically in a commodity.

Securities transactions can take several forms including sales of stocks, bonds and investment contracts.²⁵⁴ Profits from securities transactions generally result from the efforts of another person or entity.²⁵⁵ Nevertheless, a securities trade is basically a cash transaction which results in the passage of title to rights in an asset, in most cases a portion

248. For a discussion of the factors mandating a consolidation of the SEC and the CFTC, see *supra* notes 148-247 and accompanying text.

249. *Financial Market Hearings*, *supra* note 7, at 369 (testimony of Wendy Gramm, Chairperson, CFTC). Chairperson Gramm testified that "the CFTC is the professional agency that regulates futures markets. . . . I don't see anything that [jurisdictional realignment] would add, except to confusion and excess regulation and complications in the regulatory structure that already exists." *Id.*

250. See *id.* For a discussion of the nature and characteristics of futures contracts, see *supra* notes 17-23 and accompanying text.

251. Clark, *Genealogy and Genetics of "Contract of Sale of a Commodity for Future Delivery" in the Commodity Exchange Act*, 27 EMORY L. J. 1175, 1176 (1978) ("Futures contracts are not sold or traded . . . they are formed and discharged.").

252. GAO STAFF STUDY, *supra* note 17, at 63.

253. Board of Trade v. S.E.C., 677 F.2d 1137, 1139 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). For a discussion of the practice of offset, see *supra* notes 21-23 and accompanying text.

254. 15 U.S.C. § 78c(a)(10) (1988). For a discussion of securities transactions, see *supra* notes 54-56 & 66-68 and accompanying text.

255. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). The other important characteristics of a security are an investment of money and a common enterprise. *Id.*

of a corporation or other entity's profits.²⁵⁶ In addition to cash transactions, margin rules permit traders in both the securities and futures markets to acquire positions in these markets on credit with just a small initial payment.²⁵⁷

Futures and securities trades are not only similar economic transactions, they are also similar in form. On both futures and securities exchanges, trades occur in designated areas using a verbal, competitive bidding system.²⁵⁸ Thus, the economics and the form of the trade are similar enough to defeat the argument that securities and futures transactions are fundamentally different.

3. *Market Participants*

The preceding section demonstrated that, while there are some differences in the products involved in securities and futures transactions, the basic economic form of the transactions are the same: cash or credit transactions resulting in the passage of title to rights in an asset.²⁵⁹ This section will focus on the similarity between participants in the securities and futures markets,²⁶⁰ with a particular emphasis on those parties that trade in both markets.²⁶¹

Several distinct groups are involved in securities and futures trading. For the most part, participants in both the securities and futures markets can be grouped into one of the following categories: individual investors;²⁶² institutional investors;²⁶³ brokers, dealers and futures

256. *Id.*

257. See *Financial Market Hearings*, *supra* note 7, at 246 (testimony of David Ruder, Chairman, SEC). For a discussion of the role of margins in futures and securities transactions, see *supra* notes 218-27 and accompanying text.

258. GAO STAFF STUDY, *supra* note 17, at 23, 77.

259. For a discussion of the similarities between futures and securities transactions, see *supra* notes 248-58 and accompanying text.

260. For a discussion of the participants in the futures and securities markets, see *infra* notes 262-68 and accompanying text.

261. For a discussion of intermarket trading participants, see *infra* notes 270-73 and accompanying text.

262. STAFF OF HOUSE COMM. ON AGRICULTURE, 98TH CONG., 2D SESS., A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS 1-15 (1985) [hereinafter *FUTURES AND OPTIONS STUDY*].

263. *Financial Market Hearings*, *supra* note 7, at 438 (testimony of Leo Melamed, Chairman of CME). Institutional investors generally consist of mutual funds, pension and endowment funds and other commercial enterprises. *Id.* The commodity pool is the equivalent of a mutual fund, distinguished only by the fact that the commodity pool invests solely in the commodity futures markets. 1 P. JOHNSON & T. HAZEN, *supra* note 18, § 1.59. For a discussion of the role of institutional investors in the futures and securities markets, see *supra* notes 153-60 and accompanying text.

commission merchants;²⁶⁴ brokerage houses;²⁶⁵ the exchanges and industry associations;²⁶⁶ regulatory officials;²⁶⁷ and businesses and commodity producers, theoretically, the ultimate beneficiaries of securities and futures trading.²⁶⁸ The similar identities of market participants, coupled with similar transactional forms, similar regulatory structures and similar substantive laws, will facilitate the creation of a single regulatory agency with authority over both the securities and futures industries.

Perhaps the strongest evidence of the similar nature of the two markets is the incidence of investors trading in both markets. Many commentators have concluded that the securities and securities index related futures markets are, in fact, a single linked market.²⁶⁹ Market participants, using such trading strategies as portfolio insurance and index arbitrage, trade simultaneously in both markets, thereby strengthening the ties between the markets.²⁷⁰ In addition to the forms of intermarket trading, a 1985 government study indicated that most participants in the futures markets had also invested in securities.²⁷¹ Market participants who have traded in both markets, sometimes using the markets interchangeably, have been subject to regulation by two independent federal agencies.²⁷² The similar identity of the market participants would facilitate the consolidation of the SEC and CFTC into a single regulatory agency, thereby ending such unnecessarily duplicative regulation.

264. A broker is "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4) (1988). A dealer is "any person engaged in the business of buying and selling securities for his own account." *Id.* § 78c(a)(5). A futures commission merchant is an individual or other entity "engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market." 7 U.S.C. § 2 (1988).

265. GAO STAFF STUDY, *supra* note 17, at 23, 63.

266. *Id.* at 39, 76. For a discussion of the similarity between the regulatory structures involved, see *infra* notes 274-78 and accompanying text.

267. For a discussion of the similarities between the regulation of the futures and securities industries, see *infra* notes 274-302 and accompanying text.

268. GAO STAFF STUDY, *supra* note 17, at 22, 64-67.

269. See BRADY REPORT, *supra* note 8, at vi; *Financial Market Hearings*, *supra* note 7, at 355 (testimony of Wendy Gramm, Chairperson, CFTC) ("futures markets are linked to the underlying cash [securities] markets").

270. *Financial Market Hearings*, *supra* note 7, at 258-59 (testimony of David Ruder, Chairman, SEC) ("[T]he primary use to stock index futures . . . is to execute transactions in which futures are used as a direct substitute for . . . stocks."). For a discussion of index arbitrage, see *supra* notes 170-74 and accompanying text. For a discussion of portfolio insurance, see *supra* notes 164-69 and accompanying text.

271. FUTURES AND OPTIONS STUDY, *supra* note 262, at I-15.

272. See BRADY REPORT, *supra* note 8, at 55-57 (single market theory proposed and analyzed).

F. *Similarity of Regulation*1. *Introduction*

The securities and futures industries are subject to similar forms of regulation for two reasons. First, because the CFTC was patterned after the SEC, it employs the same basic style of regulatory oversight as the SEC.²⁷³ Second, the substantive offenses under futures law closely resemble the offenses under the federal securities laws, a fact which is directly attributable to the similarities between futures and securities transactions. Therefore, the similar regulation of the two industries would facilitate a consolidation of the CFTC and the SEC.

2. *Regulatory Structure*

Congress created the CFTC in 1974 after the SEC refused the invitation to assume jurisdiction over the futures industry.²⁷⁴ Although the SEC did not accept the task, it served as the pattern for the newly-created agency, the CFTC, which was granted regulatory jurisdiction over the futures industry.²⁷⁵ The most important organizational similarity between the agencies is their regulatory oversight structure. Both agencies serve as the ultimate overseer of a system of industry self-regulation.²⁷⁶ The most basic elements of this regulatory structure are the self regulatory organizations (SROs), consisting of the exchanges and the industry associations, the National Association of Securities Dealers, and the National Futures Association.²⁷⁷ The SROs conduct the day-to-day regulation of their own operations, while the agencies oversee the SROs' efforts, acting whenever the efforts fail either to ensure a fair and orderly market or to protect the public interest.²⁷⁸ Because both industries are subject to the same basic regulatory system, the creation of a new federal agency, with authority over both industries, employing the same system of agency oversight of industry self-regulation, would not

273. See Schneider & Schapiro, *supra* note 2, at 78 (CFTC modeled after SEC); GAO STAFF STUDY, *supra* note 17, at 70 (futures and securities industries both operate under scheme of self-regulation with federal oversight). For a discussion of the similar regulatory systems governing the futures and securities industries, see *infra* notes 279-84 and accompanying text.

274. Schneider & Schapiro, *supra* note 2, at 71.

275. *Id.* at 78.

276. GAO STAFF STUDY, *supra* note 17, at 70.

277. *Id.*

278. *Id.* at 39, 76. The SROs are responsible for, among other things, establishing rules for trading and membership qualifications, monitoring daily trading activity, investigating potential rules violations and disciplining violators. *Id.* The agencies are responsible for, among other things, approving SRO rules, establishing rules for the registration of firms and individuals involved in trading, monitoring trading, investigating suspicious trading activity, inspecting the SROs to ensure compliance with agency rules and compliance measures, and investigating and enforcing the provisions of the governing statutes. *Id.* at 38-51, 77-88.

impose a hardship on either industry. Therefore, the similar regulation of the futures and securities industries would facilitate a consolidation of the CFTC and the SEC.

3. *Substantive Law*

The futures and securities industries are further subject to similar regulation because the substantive laws governing the two industries are alike. The substantive laws have developed similarly for two reasons. First, the substantive laws reflect the fact that securities and futures transactions are comparable in nature.²⁷⁹ Second, judges often apply securities law precedents to cases involving futures law when no corresponding futures precedent exists.²⁸⁰ The substantive laws governing the futures and securities industries can be grouped into two categories: those protecting the integrity of the market as a whole²⁸¹ and those protecting market participants from abuses by other market participants.²⁸²

The best example of a substantive provision directed at protecting market integrity is the prohibition against price manipulation. Both the Commodities Exchange Act and the Securities Exchange Act prohibit, either implicitly or explicitly, manipulative conduct; but, neither statute defines manipulation.²⁸³ Courts interpreting both acts, however, have held that the primary element of price manipulation is simply the intent

279. For a discussion of the similarities between futures and securities transactions, see *supra* notes 248-58 and accompanying text.

280. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982) (finding an implied cause of action under Commodities Exchange Act); *Roche v. E.F. Hutton & Co.*, 603 F. Supp. 1411 (M.D. Pa. 1984) (allegation of "churning" stated cause of action under Rule 10b-5 of Securities Exchange Act and § 4b of the Commodities Exchange Act); *CFTC v. J.S. Love & Assoc. Options, Ltd.*, 422 F. Supp. 652, 661 (S.D.N.Y. 1976) ("in all material respects [§ 13a of the Commodities Exchange Act] is the same as that in the Securities Exchange Act of 1934, § 21(e) Accordingly, case law developed under the securities laws is pertinent to cases under § 13a-1 of the [Commodities Exchange] Act, such as this one."). Although the CFTC has readily grasped the substantive holding of *J.S. Love*, it has argued against the unfettered application of securities laws precedents to futures cases. 3 P. JOHNSON & T. HAZEN, *supra* note 18, § 5.39.

281. For a discussion of substantive laws designed to protect the integrity of the market, see *infra* notes 283-296 and accompanying text.

282. For a discussion of substantive laws designed to protect market participants from the abuses of other market participants, see *infra* notes 297-302 and accompanying text.

283. 15 U.S.C. §§ 78i, 78j(b), 78o(c) (1988) (prohibition of manipulation in securities transactions); 7 U.S.C. §§ 5, 7(d), 9, 13(b) (1988) (prohibition of manipulation in futures transactions). Section 9 of the Securities Exchange Act prohibits manipulative activity on national securities exchanges, § 10(b) prohibits manipulative activity in connection with the purchase or sale of securities, and § 15(c) prohibits manipulative activity by broker-dealers and extends to the over-the-counter market. 15 U.S.C. §§ 78i, 78j(b), 78o(c) (1988).

Section 3 of the Commodities Exchange Act reflects a general congressional recognition that futures markets are prone to manipulation, § 5(d) requires boards of trade to have rules prohibiting manipulation, and §§ 6(b) and 6(c)

to manipulate the price of a security or futures contract.²⁸⁴ In addition, both acts prohibit similar types of conduct. The Commodities Exchange Act prohibits transactions known as either a “‘wash sale’, ‘cross trade’ or ‘accommodation trade’ ”²⁸⁵ while the Securities Exchange Act prohibits transactions “[f]or the purpose of creating a false or misleading appearance of active trading.”²⁸⁶

Two other forms of prohibited trading impact on the integrity of the market. The first form of trading, frontrunning, involves the placing of orders based on nonpublic knowledge of an impending large block trade.²⁸⁷ Although neither statute specifically prohibits frontrunning, both agencies assert that other provisions implicitly forbid the practice.²⁸⁸ Intermarket frontrunning, trading in index futures based on inside knowledge of impending trades in the securities markets and vice-versa,²⁸⁹ has been the most vilified form of the practice²⁹⁰ and has been the subject of negotiations between the New York Stock Exchange and the Chicago Mercantile Exchange.²⁹¹

permit enforcement actions against manipulators. 7 U.S.C. §§ 5, 7(d), 9, 13b (1988).

284. *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (“[M]anipulation refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (“[M]anipulation connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”); *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) (“The aim [when looking for manipulative conduct] must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a [futures] price which does not reflect basic forces of supply and demand.”), *cert. denied*, 406 U.S. 932 (1972).

285. 7 U.S.C. § 6c(a)(A) (1988). Wash sales are simultaneous purchases and sales of securities or futures which are made not for profit potential but to create the impression of trading volume. 3 P. JOHNSON & T. HAZEN, *supra* note 18, § 5.38. A cross trade in the futures industry occurs when a futures contract merchant fills a customer’s order by simply matching that order with another customer’s opposite order instead of offering the order to competitive bidding in the pits. *Id.*

286. 15 U.S.C. § 78i(a)(1) (1988).

287. See SEC CRASH REPORT, *supra* note 67, at 3-30; Schneider & Schapiro, *supra* note 2, at 87.

288. SEC CRASH REPORT, *supra* note 67, at 3-30 to 3-31 (securities exchanges’ rules indirectly prohibit frontrunning); CFTC CRASH REPORT, *supra* note 186, at 198 & n.111, 199 (frontrunning indirectly prohibited by §§ 4b and 9b of the CEA; all exchanges selling index futures prohibit frontrunning).

289. CFTC CRASH REPORT, *supra* note 186, at 197.

290. See, e.g., *Market Reform Hearings*, *supra* note 64, at 144-45 (statement of Jeffrey Lane, President and Chief Operating Officer, Shearson Lehman Hutton, Inc.) (clearer standards on intermarket frontrunning needed).

291. See *Financial Market Hearings*, *supra* note 7, at 470 (testimony of John Phelan, Chairman and CEO, NYSE). The New York Stock Exchange has since promulgated a rule, which the SEC has approved, prohibiting intermarket front-running. *Market Reform Hearings*, *supra* note 64, at 41 (testimony of John Phelan, Chairman and CEO, NYSE).

The second form of trading, insider trading, is a variant of frontrunning. Insider trading refers to the practice of trading on the basis of material, nonpublic information while owing a fiduciary duty to some entity involved in the transaction.²⁹² Although not specifically prohibited by the Securities Exchange Act, insider trading is considered a violation of Rule 10b-5.²⁹³ Presently, however, insider trading does not violate the Commodities Exchange Act.²⁹⁴ In fact, many futures industry participants argue that insider trading plays a legitimate role in the futures market.²⁹⁵ Nevertheless, a recent bill introduced in the Senate would make insider trading an express violation of the Commodities Exchange Act.²⁹⁶

The second category of substantive laws are those provisions intended to protect market participants from abuses by other market participants, particularly brokers and futures contract merchants.²⁹⁷ Among the abuses proscribed by both the futures law and the federal

292. *Chiarella v. United States*, 445 U.S. 222, 225, 230 (1980) (insider has duty to disclose nonpublic information or to refrain from trading).

293. *Id.* Once a substantive violation of Rule 10b-5 is established, the insider may be subject to civil liability to contemporaneous traders under § 20A of the Securities Exchange Act, civil penalties under § 21A of the Securities Exchange Act and criminal penalties under § 32. 15 U.S.C. §§ 78t-1, 78u-1, 78ff (1988). The civil liability sections were added to the Act by the Insider Trading and Securities Fraud Enforcement Act of 1988. *Id.* § 78u-1.

294. Raiser & Morgen, *Insider Trading Under the Commodities Exchange Act*, in *NEW DEVELOPMENTS IN COMMODITY FUTURES REGULATION AND ENFORCEMENT* 1989, at 126 (1989) (Practising Law Institute, Corporate Law and Practice Course Handbook No. 667). The only parties subject to insider trading prohibitions under the Commodities Exchange Act are employees of the CFTC. 7 U.S.C. § 13(d) (1988).

295. See Schneider & Schapiro, *supra* note 2, at 88. The futures industry argues that trading on the basis of nonpublic information is legitimate because it furthers the price discovery and hedging roles of futures. *Id.*

296. S. 1729, 101st Cong., 1st Sess. (1989). The bill, known as the Futures Trading Practices Act of 1989, was tied to the CFTC reauthorization bill. *Id.* The insider trading provisions of the bill are applicable only to exchange and National Futures Association Officials, however. *Id.* Thus, the average futures trader still would not be prohibited from trading on the basis of nonpublic information under this bill. *Id.* It is important to note that the House version of this bill, known as the Commodity Futures Improvements Act of 1989, did not contain an insider trading prohibition. H.R. 2869, 101st Cong., 1st Sess. (1989). The Futures Trading Practices Act and the CFTC reauthorization bill were held up in Congress because of the ongoing jurisdictional dispute. *Senators Fail in Last Minute Effort to Resolve SEC-CFTC Jurisdiction Dispute*, 22 Sec. Reg. & L. Rep. (BNA) No. 41, 1476 (Oct. 19, 1990). For a discussion of the most recent disputes and proposals, see *supra* notes 125-47 and accompanying text.

297. For a discussion of the various market participants, see *supra* notes 262-68 and accompanying text.

securities laws are churning,²⁹⁸ unauthorized trading,²⁹⁹ bucketing,³⁰⁰ and fraud.³⁰¹ The similarity between such provisions stems from the similarity between futures and securities transactions and similar market participants.³⁰² Thus, a single federal agency faced with similar transactions, participants and substantive laws would have little difficulty in effectively asserting immediate regulatory authority over both the futures and securities industries.

VII. CONCLUSION

Ever since the CFTC came into existence, it and the SEC have battled over the boundaries of their respective jurisdictions. Congress, commentators and even the agencies themselves have proposed measures for resolving these conflicts, but to no avail. In the years since the 1987 market break, the agencies have expended considerable resources defending their respective positions—the SEC aggressively demanding a

298. See *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1207 (9th Cir. 1970) (churning violates Rule 10b-5 of the Securities Exchange Act); *Roche v. E.F. Hutton & Co.*, 603 F. Supp. 1411, 1414-15 (M.D. Pa. 1984) (allegation of churning states cause of action under § 4b of the Commodities Exchange Act and Rule 10b-5 of the Securities Exchange Act); 17 C.F.R. § 240.15c1-7 (1976) (churning as a “manipulative, deceptive or other fraudulent device or contrivance”). Churning refers to excessive trading in a discretionary account by a broker or futures contract merchant. 3 P. JOHNSON & T. HAZEN, *supra* note 18, § 5.45. The primary motivation behind such conduct is the generation of excessive commissions. *Id.*

299. 17 C.F.R. § 166.2 (1991) (requiring either customer authorization of futures trades or trading in an authorized discretionary account); see also *Nye v. Blyth Eastment & Dillon, Co.*, 588 F.2d 1189 (8th Cir. 1978) (unauthorized trading violation of Rule 10b-5 of Securities Exchange Act); *Silverman v. CFTC*, 549 F.2d 28 (7th Cir. 1977) (twenty-three unauthorized trades constituted violation of § 4b of Commodities Exchange Act).

300. *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 670-73 (S.D.N.Y.) (delaying execution of customer's order while broker sells own securities of same class), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966). Bucketing generally refers to “any practice whereby an order is deprived of competitive execution in the trading arena during normal trading hours.” 3 P. JOHNSON & T. HAZEN, *supra* note 18, § 5.37.

301. 15 U.S.C. § 10(b) (1988); 17 C.F.R. 240.10b-5 (1951). In order to state a claim of fraud under Rule 10b-5, a plaintiff must prove that the defendant acted with scienter, which is the intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976); see also 7 U.S.C. § 6b (1988). Courts interpreting § 4b of the Commodities Exchange Act have split on the issue of the degree of scienter required to prove fraud. Compare *McCurnin v. Kohlmeyer & Co.*, 347 F. Supp. 573 (E.D. La. 1972), *aff'd*, 477 F.2d 113 (5th Cir. 1973) (§ 4b requires willful conduct) with *CFTC v. J.S. Love & Assocs. Options, Ltd.*, 422 F. Supp. 652, 660 (S.D.N.Y. 1976) (willfulness not required under § 4b; applied securities definition of scienter). The CFTC staff argues strenuously that *J.S. Love* represents the proper standard for scienter. 3 P. JOHNSON & T. HAZEN, *supra* note 18, § 5.39.

302. For a discussion of the similarity between futures and securities transactions, see *supra* notes 248-58 and accompanying text. For a discussion of the similar market participants, see *supra* notes 262-68 and accompanying text.

1991]

COMMENT

1217

merger of the agencies and the CFTC fighting for its very existence. Since the *Chicago Mercantile* decision, the conflicts have escalated to a point where the agencies have been described as “juvenile.” One can only wonder how much further the agencies are willing to carry their fight. Such escalation, however, can only harm the exchanges, investors, businesses and other entities that rely on the integrity of the futures and securities markets. For these reasons, Congress must consolidate the SEC and the CFTC into a single regulatory agency with authority over both the securities and futures industries.

John D. Benson

